[H.A.S.C. No. 99-17]

HEARING

ON

H.R. 2397
ALLOWABLE COST REFORM ACT

BEFORE THE

INVESTIGATIONS SUBCOMMITTEE

OF THE

COMMITTEE ON ARMED SERVICES
HOUSE OF REPRESENTATIVES

NINETY-NINTH CONGRESS

FIRST SESSION

MAY 20, 1985

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99TH CONGRESS
1ST SESSION

H. R. 2397

To limit the payment of costs to defense contractors.

IN THE HOUSE OF REPRESENTATIVES

MAY 7, 1985

Mr. NICHOLS (for himself, Mr. BENNETT, and Mr. HOPKINS) introduced the following bill; which was referred to the Committee on Armed Services

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A BILL

To limit the payment of costs to defense contractors.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Allowable Cost Reform Act".

SEC. 2. ALLOWABLE CONTRACT COSTS.

(a) PENALTY FOR SUBMISSION OF UNALLOWABLE COSTS.—The Secretary of Defense shall require that a covered contract provide that—

(1) if the contractor submits for reimbursement any cost that has been expressly defined as unallowable by statute or regulation—

(A) the cost shall be disallowed; and

(B) the contractor shall be liable to the United States for an amount equal to the amount of the disallowed cost, plus interest; and

(2) if the contractor submits for reimbursement any cost of a type that has been expressly defined as unallowable by statute or regulation and that has been previously disallowed to that contractor—

(A) the cost shall be disallowed; and

(B) the contractor shall be liable to the United States for an amount equal to twice the amount of the disallowed cost, plus interest.

Interest under this subsection shall be computed from the date on which the request for reimbursement of the cost was submitted and at the applicable rate prescribed by the Secretary of the Treasury under section 611 of the Contract Disputes Act of 1978.

(b) UNALLOWABLE COSTS.—The following costs shall not be allowed under a covered contract:

(1) Costs of amusement, diversion, and social activities and any costs directly associated with such

costs (such as tickets to shows or sports events, meals, lodging, rentals, transportation, and gratuities).

(2) Costs incurred to influence (directly or indirectly) congressional action on any legislation or appropriation matters pending before Congress.

(3) Defense of any fraud proceeding brought by the United States, unless the contractor is found not to be liable in any way for the alleged fraud.

(4) Fines and penalties resulting from violations of, or failure of the contractor to comply with, Federal, State, or local laws and regulations, except when incurred as a result of compliance with specific terms and conditions of the contract or written instructions from the contracting officer.

(5) Costs of membership in any social or dining club or organization.

(6) Alcoholic beverages.

(7) Contributions or donations, regardless of the recipient.

(8) Advertising designed to promote the contractor or its products.

(9) Models, gifts, souvenirs, or other memoribilia.

(c) REGULATIONS RELATING TO ALLOWABLE COSTS.—(1) Within 120 days after the date of the enactment of this Act, the Secretary of Defense shall publish proposed regulations to amend those provisions of the Department of Defense supplement to the Federal Acquisition Regulation that deal with the allowability of contractor costs reimbursed under Government contracts. In developing specific criteria for the allowability of such costs, the Secretary shall consider whether reimbursement of such costs by the Government is in the best interests of the United States. The amendments—

(A) shall define in detail and in specific terms those costs that are unallowable under contracts entered into by the Department of Defense; and

(B) shall provide that costs specifically unallowable under one cost principle shall not be allowable under related cost principles.

(2) The amendments under paragraph (1) shall at a minimum clarify the cost principles applicable to contractor costs of the following:

(A) Air shows.

(B) Advertising.

(C) Recruitment.

(D) Entertainment.

(E) Employee morale and welfare.

(F) Social and dining clubs or organizations.

(G) Contributions or donations.

(H) Community relations.

(I) Defense of fraud proceedings.

(J) Fines and penalties.

(K) Dining facilities.

(L) Professional and consulting services.

(M) Compensation.

(N) Selling and marketing.

(O) Travel.

(P) Lobbying.

(Q) Public relations.

(R) Hotel and meal expenses.

(S) Membership in civic, community, and professional organizations.

(3) Such amendments shall require that a contractor be required to provide sufficient documentation to support the allowability of a cost at the time cost and pricing data is submitted to the Government pursuant to section 2306 of title 10, United States Code, or at the time a proposed forward pricing agreement or proposal for final settlement is submitted to the Government. If a claim is not supported by adequate documentation, the cost becomes expressly unallowable and is not subject to negotiation.

(4) Within 90 days of the date of the enactment of this Act, the Secretary of Defense shall submit to the Committees on Armed Services of the Senate and House of Representatives a report identifying—

(A) the nature of the proposed changes to be made to the current cost principles; and

(B) the potential effect of such changes on future requests for reimbursement of contractor costs.

(d) RESOLUTION OF ALLOWABLE EXPENSES.—The Secretary of Defense shall—

(1) require the negotiation and settlement of each item of cost under a covered contract which is challenged by the Government as being unallowable; and

(2) provide that, whenever feasible and practicable, the contract auditor may be present at any negotiation or meeting with the contractor regarding resolution of allowability of costs submitted to the Government for payment.

(e) CERTIFICATION OF ALLOWABLE INDIRECT COSTS.—(1) If a contractor submits a request for reimbursement of indirect costs for final settlement under a covered contract, the contractor shall be required to certify that all indirect costs included in the request are allowable in accordance with the terms of the contract. Any such certification shall be in a form prescribed by the Secretary of Defense.

(2) The Secretary of Defense or the Secretary of the military department concerned may waive the requirement for certification under paragraph (1) in the case of any contract in an exceptional case if the Secretary—

(A) determines that it would not be in the interest of the United States to require such certification; and

(B) states in writing the reasons for that determination.

(f) LIMITATION ON LENGTH OF DUTY ASSIGNMENT FOR CERTAIN CONTRACTING OFFICIALS.—The Secretaries of the military departments and Directors of the Defense Agencies shall prescribe regulations—

(1) to limit to five years the maximum tour of duty for which an officer or employee under the jurisdiction of the Secretary may be assigned to represent the Government with a particular contractor in the decisionmaking position as corporate administrative contracting officer or administrative contracting officer; and

(2) to provide that an officer or employee who has held a position in paragraph (1) may not be reassigned to duty with that contractor for a period of five years after the end of the previous such assignment.

(g) DEFINITION OF COVERED CONTRACT.—For the purposes of this section, the term "covered contract" means a contract with the Department of Defense for an amount more than $25,000—

(1) that is flexibly priced; or

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(2) for which cost or pricing data is required under section 2306(f) of title 10, United States Code.

H.R. 2397, THE ALLOWABLE COST REFORM ACT

House of Representatives,
Committee on Armed Services,
Investigations Subcommittee,
Washington, DC, Monday, May 20, 1985.

The subcommittee met, pursuant to notice, at 9:30 a.m., in room 2212, Rayburn House Office Building, Hon. Bill Nichols (chairman of the subcommittee) presiding.

OPENING STATEMENT OF HON. BILL NICHOLS, A REPRESENTATIVE FROM ALABAMA, CHAIRMAN, INVESTIGATIONS SUBCOMMITTEE

Mr. Nichols. The subcommittee will come to order.

The subcommittee is meeting this morning to consider H.R. 2397, the Allowable Cost Reform Act. The bill was introduced on May 7 as a result of the findings of the committee auditors in our recent review of the indirect cost submissions of seven defense contractors.

That review convinced us that the process for the submission, audit and settlement of the contractors' overhead costs required improvement. We found that, even though the contractors voluntarily deleted large amounts which they considered unallowable from their overhead before submitting them, the government auditors still find many more items which they consider not allowable under defense acquisition regulations. This is because of the ambiguity of many of the regulations.

We developed H.R. 2397 to attempt to correct deficiencies in the cost review process.

First, in order to discourage the submission of costs which are clearly unallowable, we have provided monetary penalties. In the first instance of the submission of a clearly unallowable cost, the item would be disallowed and the contractor would be penalized an amount equal to the item. In the case of a subsequent submission of a cost that has been previously disallowed, the item would again be disallowed and the contractor penalized an amount twice the amount of the disallowed cost.

We have also identified nine types of overhead costs which will not be allowed. They include entertainment, lobbying, defense of fraud proceedings, fines and penalties, membership in dining or social clubs, alcoholic beverages, contributions and donations, advertising of products and models, souvenirs, and other memorabilia.

We have directed the Secretary of Defense to publish within 120 days proposed regulations to amend the defense supplemental to the Federal acquisition regulations dealing with reimbursed contractor costs. This should define in detail the costs which are unallowable, and provides those costs specifically unallowable under one cost principle shall not be allowable under another principle.

We then specify 19 cost principles which must be clarified.

The bill also requires that the contractor must provide sufficient documentation to support the allowability of a cost at the time he submits it. The Secretary is required to report to the Congress on the nature of the proposed changes and their potential effect within 90 days of enactment.

H.R. 2397 also requires item-by-item negotiation of disputed costs and provides the government auditors should be present at negotiations and meetings whenever feasible and practicable.

It requires the contractor to certify that all indirect costs included in his request are indeed allowable.

The bill would also place a 5-year limit on the assignment of a contracting officer to a particular contractor facility, and further prohibits his reassignment to that contractor within 5 years.

The provisions of H.R. 2397 would apply to all Department of Defense contracts in excess of $25,000.

Today we have invited representatives from the Department of Defense, the General Accounting Office, and the National Security Industrial Association to comment on the provisions of the bill; but before hearing from those witnesses, we will call upon our colleague, Mr. Bennett, who is a sponsor of the bill and who has worked diligently on the preparation of the bill.

Mr. Bennett, we welcome you to our subcommittee this morning.

STATEMENT OF HON. CHARLES E. BENNETT, A REPRESENTATIVE FROM FLORIDA

Mr. Bennett. Thank you very much.

I will just make a few informal remarks.

First, I would like to say communication has a lot to do with what we are doing here, because sometimes things are not addressed in a way which is really quite factual due to the lack of communication. A good example is the controversy now about the $4 or $5 billion that Secretary Weinberger has found that has not been spent. That is really not much news.

In the Seapower Subcommittee, Secretary Lehman has been reporting to us the things saved because we are having underruns rather than overruns in the production of ships, so a lot of money has been saved. That is a very positive thing. As a result, we were able to build practically almost the same number of ships this year, even after making the cut in the budget because of that express finding by the Secretary of the Navy.

There was nothing secret about it. We ought to be glad that such underruns have occurred. When we have overruns, they are heavily stated as they should be. I am saying that because there is a lack of communication somewhat in the problem of why we are here today. It is not that everybody is trying to gyp the Government or be corrupt. A lot of things are things which are not readily observable because of the way they are presented.

Part of this is the fault, I think, of the people in the bureaucracy. For instance, it took us a long time to find out about what was the source of the overhead being applied to the famous expensive hammer. We found out it was apparently the result of a regulation by the Department of Defense that the overhead should be imposed upon the hammer which was a mistake to begin with to do it that way; but it was done that way and, because of the DOD itself, so you have screamer headlines, which nobody is ever going to forget, about the expensive hammer; but it was brought about by regulations in the DOD which required the overhead be applied that way.

Obviously, overhead should not have been applied that way. A logical person would say nobody is going to understand a $485 hammer, and even when reduced to $85, it got letters from the Pentagon saying, "Don't worry. We have reduced it." That is not very satisfying to say you can now buy one for four-fifths times what you need to pay for it to begin with.

This leads me to a thing I would like to observe. Two years ago, I had the opportunity to speak to leading people in defense contracting. I said I used to be a lawyer and we had a grievance committee which decided whether you were going to debar somebody in the legal profession. It was very much looked at. I don't know why industry does not have a similar thing itself, to see whether they make mistakes, or whether something is going in the wrong direction, why the industry doesn't please itself.

I had one of the heads of one of the big industries come to my office and talk to me about this matter and about the claims running 10 years or more in the past. A communication problem is involved in this because the public generally thinks that claims that have been put in for fantastic objectives are necessarily being approved. Of course, they are not being approved when the DOD catches them. There are some things this committee has found out, however, that will help us to catch them, because in the past they have been grouped together and sometimes there has been a consent or agreement that all these bad and good things are going to be put in there together. That allows some bad things to be taken care of.

I would like to urge that we try, in the Government and the private industry, in the production of these things, to make it make sense, to try to see that the Government does have a clear picture of the things that need to be done and that we improve our structure voluntarily, not wait as the man talking to me about the claims. He said, "I guess my employees have a tendency to put in frivolous claims knowing that a certain number of them are going to be approved by the mere process of it going down the road."

I said, "We are going to stop that." Mr. Nichols and I are going to work together to put a penalty on the company so the employees won't feel they are doing something good for the company by putting in frivolous claims against the Government.

We have come up with several bills that will be helpful, but they won't be perfect. You in the industry and the general public can help the Government a great deal if you would report and try to bring about the corrections yourself. Not everything has to be approved by statute. Some things can be done by consent of the industry itself, by looking at things. There ought to be a consortium of belief on the part of private industry to perfect these things.

Of course, we are going to put laws into effect. It is a pity that some of these laws have to be put into effect, causing more bureaucracy and spending Government money. Let's approach the matter in a cooperative manner. Although we will put good laws on the books, there will be other things that slip through. I hope private industry will help the Government to see to it that mistakes like this don't occur in the future and we don't have to have additional laws to penalize people which ought to be corrected by agreeing and working together.

Mr. NICHOLS. Thank you, Mr. Bennett.

Our next witness this morning will be Deputy Secretary of Defense William H. Taft and Mr. Charles Starrett, Director of the Defense Contract Audit Agency.

Let me thank Mr. Starrett for making available to the committee seven of your finest auditors. They were of immense help to the committee. We can't thank them enough for their fine work, particularly that of Mr. Peter Roppolo who headed the DCAA team.

We would be glad to hear your review of the bill we have before us.

STATEMENTS OF HON. WILLIAM H. TAFT IV, DEPUTY SECRETARY OF DEFENSE, DEPARTMENT OF DEFENSE; AND CHARLES O. STARRETT, JR., DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY, DEPARTMENT OF DEFENSE

Mr. TAFT. Thank you very much.

Let me say that the Department was delighted to be able to make available those auditors to you. I know that you needed them. We had discussed it and I think it was a good example of cooperation in working together, the legislative and executive branches on this serious problem.

I would like to say that I am very pleased to appear before the committee in order to discuss H.R. 2397, the Allowable Cost Reform Act.

The Department of Defense is firmly committed to getting the most defense from each tax dollar that is proposed to us and our wide ranging reform efforts now underway are helping us to achieve that important goal.

The Department shares the concerns of this committee over some defense contractors' practice of claiming reimbursement for questionable and, in some cases, clearly unallowable overhead expenses. We have already taken a number of positive steps to correct this problem, some of which have been incorporated into H.R. 2397. There are a number of other actions that we have taken that I would also like to bring to your attention at this time.

COST PRINCIPLES

First, the requirements of cost accounting standard 405, accounting for unallowable costs, have been extended to cover all contractors, not just those subject to cost accounting standards.

Second, a cost principle has become effective that disallows lobbying costs and political contributions.

Third, a cost principle has been promulgated to make unallowable the legal, consulting, professional and other costs associated with defending against charges of fraud or other improper actions.

Fourth, the definition of "reasonableness" has been revised to allow the Government to question the reasonableness of overhead costs regardless of the amount of commercial business a contractor may have. Previously, reasonableness could not be questioned where a contractor has a substantial amount of commercial business.

Fifth, a new cost principle on "public relations" has been published for public comment. The final version of that principle will be issued soon.

Sixth, a cost principle covering "travel costs" has been published for public comment. The revision would preclude reimbursement for corporate aircraft unless specifically required by contract.

Seventh, a cost principle strengthening coverage for self-insurance costs has been published.

In addition, the Defense Acquisition Regulatory Council is preparing revisions to other cost principles covering such areas as insurance, compensation, "banked" vacations, mergers and acquisitions, and employee discounts.

These actions have all been taken over the course of the last several years and they relate to what overhead costs may be billed to the Department of Defense. As you can see, they have tended to restrict, in fact uniformly they have restricted the allowability of costs that previously were allowed or were at least arguably allowed under our regulations. Under these proposals and under these actions that have taken effect they would no longer be allowable. That is the tendency that we have had over the past 4 years in the Department.

We are also concerned, of course, with the efforts of our contractors to reduce the costs that they actually incur, regardless of who may be billed for them.

On August 4 of last year, I requested the Under Secretary of Defense for Research and Engineering to lead a joint service review of what could be done to achieve efficiencies in overhead.

Based upon the joint service recommendations, on December 31, 1984, I established 10 principles of overhead cost control. The principles, which have been sent to the service secretaries and agency directors, set the direction and tone of further initiatives for developing both contractor incentives and improvements in Government oversight.

The principles were also sent to the chief executive officers of the top 30 defense contractors and presidents of major industry associations, along with the challenge to get back to me with their ideas. They have done so, and many of them are taking significant steps to improve their own control of overhead costs, which they recognize is very much in their interest in every way. Their responses have generally indicated a spirit of cooperation with the Department. I am providing to you a copy of the principles that I shared with them for the record.

At the same time, on December 31, 1984, I directed that the following actions be taken:

First, each service and the Defense Logistics Agency has begun one "should cost" review of plantwide overhead at one contractor location during fiscal year 1985. These reviews are underway.

Second, the Defense Contract Audit Agency is performing a centrally directed audit of overhead allocation bases used by the major defense contractors. There must be an assurance that overhead costs are allocated to Government contracts on a benefits-received basis. There must also be an assurance that the allocation methods used today have kept pace with changes in the nature of defense business.

Third, the relationship between overhead and the DOD profit policy is currently being examined under the defense financial and investment review.

The Department can do and has done a lot, but completing the task of most efficiently restoring our Nation's military strength also requires the cooperation of our partners in industry. The Department's conviction is that our defense contractors must assume more of the burden for correcting these "overhead" problems by identifying them and solving them at the source. This view has led us logically to the establishment of new contractor certification procedures.

On March 12, 1985, the Secretary of Defense directed that no overhead cost submissions be accepted unless a certificate of overhead costs is signed by a division vice president or equivalent from the contractor. The certificate states, under penalty of perjury, that all costs claimed are allowable in accordance with the requirements of the contracts to which they apply, and with the cost principles applicable to those contracts. We anticipate that this certification requirement will dramatically cut down the number of instances where questionable costs are claimed by contractors.

As you can see, we have already done a lot over the past 4 years to bring under control excessive, unallowable or improper contractor overhead charges. The corrective actions have been, for the most part, already set in motion, but we are continually reviewing what more we can do.

Turning to H.R. 2397, we are in complete agreement with the thrust of the legislation. We have already acted upon, and therefore obviously agree with the provisions on certification. We are currently evaluating the comments that we have received from the public on our interim regulation in that connection and will issue a final regulation in the near future.

We fully support the provision in the bill of requiring certification of overhead costs and believe it will go a long way in preventing future abuses.

We also support fully the provision requiring penalties for submission of claims for expressly unallowable costs. This would provide the Department an essential tool to assure contractor compliance with the certification requirement. These two provisions taken together will ensure that contractors behave in a responsible fashion when submitting claims to the Government for overhead costs.

We also agree as a matter of principle with the remaining provisions of the bill. We feel that the unallowable costs listed in the bill in fact be unallowable, and indeed they already are unallowable under our regulations in most cases.

We also support the provisions which require review of our cost principles. We have already reexamined many of these, and we are undertaking to review the entire body of cost principles.

We support the requirement that contractors provide adequate documentation to support the allowability of costs. We believe this provision will work most effectively if such documentation is required at the time of final settlement, when it is fully available.

We support in principle the section which requires the negotiation and settlement of each item of cost separately. We would recommend this provision apply to significant cost items when negotiating final overhead rates.

We also support the section which provides for auditors to be present at negotiations. We have already been emphasizing this practice since 1981.

We also support the idea of limiting to five years the tour of duty of a corporate administrative contracting officer or an administrative contracting officer with a particular contractor. As you know, we have had such a policy in place in DCAA for 20 years. We do, however, request that any such restrictions include waiver authority when it is in the best interests of the Department of Defense to exercise that authority.

As I have said, we support all the provisions of H.R. 2397 in principle. There is no issue as to whether these matters should become part of the way we do business in DOD. There remains, however, a question as to whether these matters should be implemented by legislation or by regulation. In some cases, we welcome the legislative approach because it is required.

For example, the certification process would be benefited by legislation that would establish beyond argument the authority of the Secretary of Defense to require such a certificate. As you know, this has been questioned by some. We discussed this when I appeared before the committee 2 months ago. Also, the imposition of penalties is best handled, in our judgment, through legislation.

In most cases, however, we need to consider the possible consequences of restricting the Department's flexibility before putting provisions into the United States code. I believe that some of these important acquisition reforms included in H.R. 2397 could be better handled through the regulatory process. Through the years, we have found that our cost principles need continual adjustment to accommodate changes in business practices, tax regulations, accounting conventions, and other public policies.

For example, employee compensation is an area where changes have been made frequently to respond to changing business practices. As new forms of compensation have been introduced, we have evaluated their reasonableness and adjusted the cost principle accordingly. This has been possible because they were in regulation rather than embodied in legislative language.

Conversely, the lack of flexibility caused by congressional action has created particular problems in the area of cost accounting standards. When the CAS board went out of existence in 1980, its promulgations were perceived to have the "full force and effect of law." Since that time, the CAS promulgations, which were designed to protect the interests of the Government, have become out of step with reality.

As a result, the Government runs the risk of being required to reimburse contractors due to loopholes that have opened in a changing business environment. For that reason, we at DOD have assumed the authorities of the former CAS board and are in the process of incorporating CAS into the Federal Acquisition Regulation. It is my belief that regulatory flexibility holds the greatest potential for efficiently and effectively dealing with the "overhead" problem.

Mr. Chairman, we agree with the thrust of this proposed legislation. We must better ensure that unallowable overhead costs are clearly defined and improper costs are clearly defined and improper costs are not charged to our defense contracts. H.R. 2397 incorporates several of the actions that we now have underway at DOD to address this problem. I think that the changes to the regulatory process that we now have set in motion can most efficiently and effectively solve much of this "overhead" cost problem and do what is envisioned by the bill.

Other provisions of the bill should be established in legislation, as I have indicated.

Thank you very much, Mr. Chairman, for the opportunity to appear before your committee and to discuss this important piece of legislation.

Mr. NICHOLS. Thank you, Mr. Secretary.

PREPARED STATEMENT OF WILLIAM H. TAFT IV

Good morning Messrs. Chairman and subcommittee members. I am pleased to have the opportunity to appear before you today to discuss H.R. 2397, the Allowable Cost Reform Act.

The Department of Defense is firmly committed to getting the most defense from each tax dollar. Our wide-reaching reform efforts now underway are helping us achieve that important goal.

The Department of Defense shares your concerns over some defense contractors' practice of claiming reimbursement for questionable and, in some cases, expressly unallowable overhead expenses. We have already taken a number of positive steps to correct this problem, some of which have been incorporated into H.R. 2397. There are a number of other actions that we have taken that I would like to bring to your attention.

1. The requirements of cost accounting standard 405, accounting for unallowable costs, have been extended to cover all contracts, not just those subject to cost accounting standards.
2. A cost principle has become effective that disallows lobbying costs and political contributions.
3. A cost principle has been promulgated to make unallowable the legal, consulting, professional and other costs associated with defending against charges of fraud or other improper action.
4. The definition of "reasonableness" has been revised to allow the government to question the reasonableness of overhead costs regardless of the amount of commercial business a contractor may have. Previously, reasonableness could not be questioned where a contractor had a substantial amount of commercial business.
5. A new cost principle on "public relations" has been published for public comment. The final version will be issued soon.
6. A cost principle covering "travel costs" has been published for public comment. The revision precludes reimbursement for corporate aircraft unless specifically required by contract.
7. A cost principle strengthening coverage for self-insurance costs has been published for public comment.

In addition, the defense acquisition regulatory (DAR) council is preparing revisions to other cost principles covering such areas as insurance, compensation, "banked" vacations, mergers and acquisitions, and employee discounts.

These actions relate to what overhead costs may be billed to the Department of Defense. We are also concerned with the efforts of our contractors to reduce the costs they actually incur, regardless of who may be billed for them. On August 4, 1984, I requested the Under Secretary of Defense for Research and Engineering to lead a joint service review of what could be done to achieve these efficiencies.

Based upon the joint service recommendations, on December 31, 1984, I established ten principles of overhead cost control. The principles, which have been sent to the service secretaries and agency directors, set the direction and tone of further initiatives for developing both contractor incentives and improvements in government oversight. The principles were also sent to the chief executive officers of the top 30 defense contractors and presidents of major industry associations, along with the challenge to get back to me with their ideas. They have done so, and many of them are taking significant steps to improve their own control of overhead costs. Their responses have generally indicated a spirit of cooperation. I am providing a copy of these principles for the record.

At the same time, on December 31, 1984, I directed that the following actions be taken:

1. Each service and the Defense Logistics Agency (DLA) has begun one "should cost" review of plant-wide overhead at one contractor location during FY 1985. These reviews are under way.

2. The defense contract audit agency is performing a centrally directed audit of overhead allocation bases used by the major defense contractors. There must be an assurance that overhead costs are allocated to government contracts on a benefits-received basis. There must also be an assurance that the allocation methods used today have kept pace with changes in the nature of defense business.

3. The relationship between overhead and the DOD profit policy is currently being examined under the defense financial and investment review.

The department can do and has done, a lot, but completing the task of most efficiently restoring our Nation's military strength also requires the cooperation of our partners in industry. The department's conviction is that our defense contractors must assume more of the burden for correcting these "overhead" problems by identifying them and solving them at the source. This view has led us logically to the establishment of new contractor certification procedures.

On March 12, 1985, the Secretary of Defense directed that no overhead cost submissions be accepted unless a certificate of overhead costs is signed by a division vice-president or equivalent from the contractor. The certificate states, under penalty of perjury, that all costs claimed are allowable in accordance with the requirements of the contracts to which they apply, and with the cost principles applicable to those contracts. We anticipate that this certification requirement will dramatically cut down the number of instances where questionable costs are claimed by contractors.

As you can see, we have already done a lot over the past four years to bring under control excessive, unallowable or improper contractor overhead charges. The corrective actions have been, for the most part, already set in motion. But we are continually reviewing what more we can do.

Turning to H.R. 2397, we are in complete agreement with the thrust of the legislation. We have already acted upon, and therefore obviously agree with the provisions on certification. We are currently evaluating the comments we have received from the public on our interim regulation and will issue a final regulation in the near future. We fully support your provision requiring certification of overhead costs and believe it will go a long way in preventing future abuses. We also support fully the provision requiring penalties for submission of claims for expressly unallowable costs. This provides the department an essential tool to assure contractor compliance with the certification requirement. These two provisions taken together will ensure that contractor will behave in a responsible fashion when submitting claims to the government for overhead costs.

We also agree as a matter of principle with the remaining provisions of the bill. We feel that the unallowable costs listed in the bill should in fact be unallowable, and indeed they already are unallowable under our regulations in most cases.

We also support the provisions which require review of our cost principles. We have already reexamined many of these, and we are undertaking to review the entire body of cost principles.

We support the requirement that contractors provide adequate documentation to support the allowability of costs. We believe this provision will work most effectively if such documentation is required at the time of final settlement, when it is fully available.

We support in principle the section which requires the negotiation and settlement of each item of cost. We would recommend this provision apply to significant cost items when negotiating final overhead rates.

We also support the section which provides for auditors to be present at negotiations, which we have already been emphasizing since 1981.

We also support the idea of limiting to five years the tour of duty of a corporate administrative contracting officer (CACO) or an administrative contracting officer (ACO) with a particular contractor. As you know, we have had such a policy in place in DCCA for 20 years. We do, however, request that any such restrictions include waiver authority when it is in the best interest of the Department of Defense.

As I have said, we support all the provisions of H.R. 2397 in principle. There is no issue as to whether these matters should become part of the way we do business in DOD. There remains, however, a question as to whether these matters should be implemented by legislation or by regulation. In some cases, we welcome the legislative approach because it is required. For example, the certification process needs legislation in order to clarify the authority of the Secretary of Defense to require such a certificate. Also, the imposition of penalities is best handled through legislation.

In most cases, however, we need to consider the possible consequences of restricting the department's flexibility before putting provisions into the United States Code. I believe that some of these important acquisition reforms included in H.R. 2397 would be better handled through the regulatory process. Through the years, we have found that our cost principles need continual adjustment to accommodate changes in business practices, tax regulations, accounting conventions, and public policies. For example, employee compensation is an area where changes have been made frequently to respond to changing business practices. As new forms of compensation have been introduced, we have evaluated their reasonableness and adjusted the cost principle accordingly.

Conversely, the lack of flexibility caused by congressional action has created particular problems in the area of cost accounting standards (CAS). When the CAS board went out of existence in 1980, its promulgations were perceived to have the "full force and effect of law." Since that time, the CAS promulgations, which were designed to protect the interest of the government, have become out of step with reality. As a result the government runs the risk of being required to reimburse contractors due to loopholes that have opened in a changing business environment. For that reason, we at DOD have assumed the authorities of the former CAS board and are in the process of incorporating CAS into the Federal acquisition regulation (FAR). It is my firm belief that regulatory flexibility holds the greatest potential for efficiently and effectively dealing with the "overhead" problem.

Mr. Chairman, we agree with the basic thrust of this proposed legislation. We must better ensure that unallowable overhead costs are clearly defined and improper costs are not charged to our defense contracts. H.R.2397 incorporates several of the actions we now have underway at DOD to address this problem. I think that the changes to the regulatory process we now have set in motion can most efficiently and effectively solve much of this "overhead" cost problem and do what is envisioned by the bill. Other provisions of the bill should be established in legislation, as I have indicated.

Thank you, this concludes my statement.

PRINCIPLES OF OVERHEAD COST CONTROL

Prospective pricing.—Priority emphasis must be placed on prospective pricing of overhead costs. Government officials must strive for cost avoidance, using fair and reasonableness criteria, before contractor overhead costs are incurred. The most effective cost control will be realized through sound forward pricing rate agreements and advance agreements negotiated between the Government and contractor.

Continous evaluation.—Effective overhead cost control begins with forward pricing and ends with final settlement. The validity of forward pricing projections must be constantly assessed, and actions to correct such projections shall be properly undertaken by Government officials.

Business base.—Future business forecasts are important in developing accurate, cost-effective overhead rates. It is imperative for Government officials to understand the contractor's budgetary systems used to estimate overhead allocation bases. The business volume underlying forward pricing rate agreements shall be regarded as cost and pricing data certified by the contractor.

Discrete cost analysis.—Overhead costs must be evaluated on an element-by-element basis that concentrates on where contractor management decisions are made. Pricing methods which place undue emphasis on historical costs must be avoided. Evaluation tools such as Should Cost, Cost Monitoring Reviews, operations audits, etc., should be used to their fullest extent.

Personnel costs.—The factors associated with contractor personnel costs, which include employee population, wage and salary structure, and fringe benefit plans, represent nearly two-thirds of all overhead costs. While there must not be any interference with industry's collective bargaining processes, the Government has a responsibility to ensure that costs absorbed on defense contracts are fair and reasonable. The Contractor Employee Compensation System Review is an important tool for evaluating these costs.

Accounting system.—Government officials must possess a thorough understanding of the cost accounting system used by the contractor. The cost accounting system must provide overhead allocation on a credible benefits-received basis, not only in the aggregate but on individual items as well. Government officials must also fully understand contractor management accounting systems, particularly as they relate to overhead planning and control.

Team approach.—Top management commitment to the team approach is absolutely essential. Contracting officers, cost and price analysts, functional experts, program managers, buying activities, and contract auditors must actively participate in all aspects of overhead cost control. Effective communication is vital.

Government requirements.—Government officials must be sensitive to the impact of their requirements on contractor overhead costs. Care should be taken through solicitation review processes to ensure that contract requirements and their attendant administration genuinely contribute to program objectives.

Contractor incentives.—Government officials are challenged to be creative in employing incentives and techniques that will give the contractor a credible inducement to reduce overhead costs. Such incentives could include contract incentives fee structure, Industrial Modernization Incentives Program, special productivity profit factor, source selection consideration, etc.

People.—Meaningful overhead cost control can only be accomplished by the diligent efforts of individual people. Top management shall ensure that adequate personnel resources are applied to this area, not only in numbers but talent as well. Recruitment, training, and retention of qualified people is a priority responsibility.

PREPARED STATEMENT OF CHARLES O. STARRETT, JR.

Mr. Chairman and members of the Joint Subcommittee, I am pleased to be here today to provide DCAA's comments on H.R. 2397, Allowable Cost Reform Act.

Subject to the Deputy Secretary's comments regarding the use of regulations to accomplish some of your objectives, I'm providing the following comments:

First, let me state I whole heartedly endorse the action you are taking to provide penalties when contractors submit unallowable costs. However, I would recommend that any penalty not include a provision for interest. Since interim billing rates established exclude unallowable costs based on current year cost projections and past audit experience, it would be difficult to determine when or if an unallowable cost was actually paid to the contractor. This would also make it difficult to calculate an interest penalty amount.

In lieu of the interest penalty, I recommend that the penalty for submitting unallowable costs the first time, as covered in Section 2.(a)(1), be double the amount of the disallowed cost. The penalty for submitting a previously disallowed cost, as covered in Section 2.(a)(2), should be three times the amount of the cost disallowed. This would further incentivize the contractor to screen its costs more carefully before submitting a claim to the Government for reimbursement.

I agree with the Subcommittee's listing of unallowable costs in Section 2.(b). However, I would like to recommend adding disallowance of the costs associated with appealing contracting officers' decisions. The current cost principles provide that costs incurred in connection with the prosecution of claims against the Government are unallowable. However, the cost principles are silent with respect to appealing contracting officers' final decisions.

Both of the provisions relating to Resolution of Allowable Expenses, Section 2.(d), are endorsed by DCAA.

It was the intention of Cost Accounting Standards (CAS) 405, that costs mutually agreed to be unallowable in one negotiation, would be eliminated from all future cost submissions. Without an item by item negotiation of each significant cost item questioned, the benefits of this provision of CAS 405 are lost, and the auditor is required to audit the same unallowable costs year after year. I would recommend that the wording in Section 2.(d)(1) be changed to read "the Secretary of Defense shall—require the negotiation and settlement of each significant item of cost in the final overhead rate . . . . "

DCAA has strongly emphasized the need to attend negotiations since 1981; both fact finding and negotiation conferences when applicable. As a result, the percent of our costs questioned sustained by contracting officers has increased, resulting in even greater savings to the taxpayers.

With respect to Limitation of Duty Assignment for Certain Contracting Officials, Section 2.(f), I am pleased to say that DCAA has had a similar rotation policy for most of our 20 years of existence. The advantages of a strong rotation program are to assure that audit objectivity and independence are maintained, and at the same time a rotation program broadens the employee's experience base by becoming familiar with a variety of contractors' business management systems. We also endorse the use of a uniform and mandatory rotation policy for other Government employees who represent the Government with a particular contractor in decisionmaking position. This certainly includes corporate administrative contracting officers and administrative contracting officers.

In conclusion, subject to the Deputy Secretary's comments regarding regulations, the Defense Contract Audit Agency endorses H.R. 2397 and suggests the modifications discussed in this statement.

I would be pleased to answer any questions the Members might have at this time.

Mr. NICHOLS. What you seem to be saying to the committee, is that we don't need any bill to do this. The regulations are going to clean this up entirely like the driven snow.

First, let me tell you that by nature, I have never been a muckraker. I don't like the position that I have trying to get somebody's attention by fines or penalties.

We have people that even talk about jail sentences. That is not included in this bill; but let me ask you, how would you go about getting the attention of the contractors on this sort of thing?

Obviously, this has been going on for a good long while and you say, "Let us clean it up and we will do it by regulation; you don't need any law." You came before this committee on March 14, and we talked about General Dynamics having charged the Government for boarding a dog and a chili cook-off. And you said that you felt that these were unusual or extraordinary claims.

Let me remind you that, in the interim, we have sent 14 auditors out to seven of our largest defense contractors. Frankly, we hoped that this was just an unusual sort of thing, that it wasn't prevalent with all of the contractors. But we didn't find that when they came back. They reported such instances as parking tickets that were being charged to the Government; paper airplane contests; barber shop expenses, and that two of them had actually submitted claims far in excess of those claims that were submitted by General Dynamics.

I guess what I am asking you is to tell us how you are going to get somebody's attention through regulations. We haven't been able to do it in the past. Why do you think we are going to be able to do it now?

Mr. TAFT. Well, Mr. Chairman, let me first of all say that I am not saying that we can do all of the things through regulation that you can do through legislation. I think I identified specifically two things that we could not do as effectively through regulation. I support strongly the legislative base for our actions in that area, particularly penalties which, as I pointed out, are much better based in legislation than in regulation. We welcome those provisions of the bill.

Frankly, I think that those penalties are one of the best ways of getting the attention of the contractors and we support those provisions that impose penalties on contractors who submit unallowable costs.

My reservations about legislation versus regulation really go only to the definition of what is an allowable or an unallowable cost. It seems to me that the changing business practices require a flexibility in the Government to respond to developing situations, for example, as in workmen's compensation or in insurance practices, that the regulatory approach is better able to accommodate.

If the legislation—I don't object at all, in fact, as I said, we support making these costs unallowable. They already are unallowable, in overview, and the backup of legislation is obviously helpful. Legislation it also has this drawback, which we experienced in the cost accounting standards situation, of taking longer to respond, to amend, when a business situation changes. I thought in fairness I ought to point that out to the committee.

It is a consideration that I know you are well familiar with. We don't have a difference with the committee on the desirability of making these costs unallowable at all. We are with you. And if legislation is the route that you prefer to go, we don't have, as I say, any substantive disagreement. We do point out the drawback in terms of flexibility.

Mr. NICHOLS. Well, I think legislation is the route that the American public is expecting this Armed Services Committee and this Congress to go. They are fed up with this, Mr. Secretary. They have got a belly full of it, and they are expecting this Congress to do something about it.

Let me ask you a somewhat related question. The American public today is going to read that the military has received about $18 billion in a windfall that has come about because of overestimated inflation that didn't occur, thankfully.

When we get to the floor with this bill, I am sure we are going to be deluged by Members of Congress who are going to demand to know where those billions of dollars went—the $18 billion, plus the additional $4 billion that the Secretary disclosed over on the Senate side some time last week—how are we to respond to that? Where is this money? Do you have it over there? Has it been spent? We need to have some accountability of it.

Mr. TAFT. Well, Mr. Chairman, let me say—and I think Congressman Bennett spoke very accurately to this subject in his opening statement—I think it is very regrettable that words like "windfall" or "secret" or "hidden" or anything of the kind are being applied to this, to these basically what have been savings that have been realized by the Department in the execution of its programs over the past 14 years.

Without going into the numbers, which are large—I have not looked at the chairman's mathematics and indeed he didn't really stand behind it in any detail as to what amounts are involved, but there is no question about that over the past 4 years, the Department has executed the defense program for a great deal less money than the Congress felt it was going to require to execute that program.

The reasons for this are essentially two: the inflation rate as a result of the administration's policies has been lower than anybody anticipated; and the Department's management of its programs has been better than anybody anticipated.

The savings are in certainly the billions of dollars. This is basically good news; not bad. When we have these savings, we report them to the committees, the Armed Services Committees and the Appropriations Committees. They take them into account and reflect them in their authorization bills and appropriation bills in subsequent years, and in so doing, the savings are realized by the taxpayers.

This is exactly what has been done with the $4 billion to which you referred, which is basically savings in the execution of the 1985 budget. What the Department recommended, as it has in previous years, is that these savings that have been realized be used by the Congress to reduce the amount of money that it needs in the 1986 program. That is very good news for the Department and for the public. It means we get more defense for less money, which I always thought was what we wanted.

Mr. NICHOLS. I just want to remind you, Mr. Secretary, we marked up the House version of the defense authorization bill. To my knowledge, we haven't had any report from the Department of Defense of any $18 billion worth of money floating around over there that we didn't spend. I think it is great that these savings have occurred; and, if that is true, I commend you on the improvements over there.

Mr. TAFT. I think that is what the chairman's statement said, was that they had been realized over the past 4 years, and that—we have been saying this for many years. We haven't been able to get as much attention to our achievement as I would like, but I am glad to have the opportunity to repeat it here today. We have saved money in the Department.

Mr. NICHOLS. Mr. Bennett.

Mr. BENNETT. Following up on that, money in the Department of Defense for underruns and savings would not be capable of being spent for any unauthorized project, would it?

Mr. TAFT. It certainly would not, Mr. Chairman. We have, as you know, a reprogramming system that requires us to obtain the permission and approval of the four committees of Congress to which we are responsive and responsible before we shift money from any given purpose to another.

Mr. BENNETT. What you are saying is, if there is a billion dollars or $4 billion or $18 billion or whatever the figure is, which you are not saying what the figure is, if it is not to be spent for what it is authorized to be spent for, then you have to come back to Congress and ask that money to be transferred to some other project, which has already been authorized by Congress.

Mr. TAFT. That is exactly what we have had to do. That is exactly what we have done and that frequently is approved.

Mr. BENNETT. That is exactly what we did in the Seapower Subcommittee to get the money to save the ships that otherwise would have been lost. In other words, we used the underruns to finance the cut which our committee had to take, and any other committee could have done the same thing, and none of it can be done capriciously. It all has to be done by the Department of Defense for authorized projects for which the money is specifically funded or authorized projects for which there has been a transfer in the process of reprogramming; isn't that correct?

Mr. TAFT. That is exactly correct. You did it with the *Missouri* battleship, I believe last year. You have done it again this year and we are very glad that this is possible to do.

Mr. BENNETT. In my opening remarks, I stressed the fact that communication sometimes helps in this matter. I hope the media understands what was said, because the impression that there is $18 billion floating around somewhere is not so. If it is going to be moved from the project to which the money was assigned, the Department has to come back to Congress and ask for that to be done. That is my understanding of the law. Is it your understanding, too?

Mr. TAFT. It is my understanding and I know it is Chairman Aspin's understanding, as well. He signs the letters approving these reprogrammings.

Mr. BENNETT. The chairman brought up the question of what should be in the statute and what should be in regulations. And since the chairman and I have been for generations in the government—I was born when your great grandfather was President of the United States—we know about government.

The problem is about government that, if you don't put it in statutes, the regulations sometimes don't get tended to as promptly as they should. I am sure you regret that, and your negative feeling about putting it into statute is as you realize, it takes away flexibility. We pay the penalty because of the regulation not keeping abreast. I am not sure that the regulations still are keeping abreast with regard to overhead. It is hard for me to understand that.

I have received letters from members of the Joint Chiefs saying in essence, "The $485 hammers are now reduced to $85 and you ought to feel happy about that;" but knowing nobody in the public reacts happily to an $85 hammer, I wonder what changes have taken place now with regard to overhead that still makes you have to have an $85 hammer?

Mr. TAFT. We have introduced a series of changes in 1985 affecting the allocation of overhead to spare parts and other procurement such as hammers, small procurement items, so that that would not occur. In fact, I am not familiar with the correspondence that you have had. My information is that we buy our hammers for about $7 apiece.

Mr. BENNETT. I am glad to know that is so. What have you done overall with regard to overhead, which is the most mysterious part of the regulations to understand? I am in no way running anybody down. It is difficult to understand how things so remote as to whether or not you should have a first-class ticket on an airplane, which I criticize, or an ordinary coach, get into the question of overhead for the government, I am not quite sure.

Is it true that overhead only affects non-fixed-price contracts, or does it sometimes affect fixed-price contracts, because of the fact that you have to pay some of the costs in advance to keep the company going? Am I correct in that assumption? Do you even look at, in the case of fixed price—even in those cases, I understand you still have to look at overhead, because you are not sure that they are really going ahead with the contract. Is that correct or not?

Mr. TAFT. It has an effect on fixed-price contracts, and that is one reason why we are trying not simply to correct the billing of overhead, but to encourage the contractors to hold it down, period. What is perhaps more important even than the billing of it, is if it is not incurred at all. That is the best solution.

Mr. BENNETT. That is a good answer, but it is not an answer to the question I asked. I didn't ask the question very well. I want to restate the question. I am trying to find out if the Government has to look at the overhead costs even in cases where you have a fixed price.

Mr. TAFT. The answer is that we do consider overhead in the neogitations that lead often to a fixed-price contract. We review the overhead costs that are submitted for negotiating fixed-price contracts. So it does have an impact. Over the long run, there is less of an impact there than on the costs.

Mr. BENNETT. Does a company put in claims or suggest that these are allowable costs in a fixed-price contract arrangement?

Mr. TAFT. When we negotiate a contract with somebody, even if it is a fixed-price contract, in certain circumstances we will require them to submit their costs.

Mr. Starrett is the person that audits those.

Mr. BENNETT. Why?

Mr. STARRETT. If I might, let me possibly start at the top. If we have an advertised procurement, then, of course, we are going to pay a price that is based on the marketplace and what is in overhead doesn't have anything to do with it. If we are going to negotiate a price with a company on a sole-source basis and we know what we are going to buy and can negotiate a firm fixed price, but only one supplier available, then we will negotiate the overhead as part of that firm fixed price. We will have to establish what the rates are so that when we establish and estimate the direct cost, we will be able to apply an appropriate overhead rate.

Mr. BENNETT. So you are saying in cases of a fixed-price contract, you still look into the overhead?

Mr. TAFT. We do and it is important in our assessment.

Mr. BENNETT. Is it valid that, when you have a company undertaking a very large contract, they are saying we can't continue to go on, this contractor is spending hundreds of millions of dollars and going into the red unless you currently refurbish us by giving us our costs?

Mr. TAFT. We would establish a billing rate to reflect what we consider to be their allowable overhead costs for a fixed-price contract as well.

Mr. BENNETT. I guess you would like to get rid of that responsibility, if you could. It is sad to me that, even in fixed-price contracts, you still have to look at overhead costs. It certainly costs you money to do it.

Mr. TAFT. I would like to put as much of our business as we can on competitive fixed-price bases. We have made substantial progress in that over the past 4 years. Every time you do that, you do better. Sole source is going to be more expensive for you.

Mr. **Bennett**. One other question. I realize I am talking too long. They don't have the clock going, so therefore I have been able to do it. There is one line of questioning I would like to ask which is not actually in this bill, but we are going to face it on the floor of the House, that has to do with the question of this other committee's finding, the reform caucus has some legislation that has to do with putting pressure on the Department of Defense to have fixed-price contracts competitive bidding.

Now, the fact that I am asking this question should not be construed that I feel they are going in the wrong direction. I am really asking the question to find out how practical it is to do what they have in mind; because everybody, I think, would agree that if you could have competition everywhere, it would be good or, if you could get fixed-price contracts, that would be an advantage.

I am asking you this question because I don't know anywhere else to ask; and it is going to be important to us, because it is going to come on the floor of the House. It doesn't come out of any regularly constituted committee. It comes out of the reform caucus. The thrust of the legislation is to try to put pressure on for more competitive bidding and more fixed price.

How do you feel about that legislative proposal?

Mr. **Taft**. We have, as I say, supported going more to competitive bidding and going more to fixed price. There are various pieces of legislation about, and I am not sure exactly of the provisions of the one that you are referring to, that define competition in different ways. There is competition in a negotiation posture and there is also competition in a closed bid posture. When we put things out for closed bid, those are a much smaller portion of our competitive awards than the negotiated type.

It is nice to be able to do it that way and to increase that amount, but I think some of the numbers that I have seen such as increasing the closed bid competitive awards of the Department from what they presently are, which is a little under 10 percent, to 70 percent, is not feasible when you are dealing with the complex systems that we are.

We think we get good competition in negotiated contracts and we support that.

Mr. **Nichols**. Mr. Kasich.

Mr. **Kasich**. Thank you, Mr. Chairman.

Mr. Taft, I share the chairman's frustration off the bat, because it seems to be the style at the Pentagon to say, "We have been on top of this thing for 4 years and we have cleaned it up ourselves." I guess I have to ask you a question. You remember the last time you were before this committee and I questioned you on the issue of overhead costs and Mr. Starrett was in the room at the time and I asked you whether the Pentagon had paid any of the overhead costs, that had been questioned by DCAA auditors. At that time, you told me no.

I wonder if you would answer the question as to whether we paid out of the Pentagon any of those overhead costs that the DCAA had said were not allowable?

Mr. **Taft**. I think what we were discussing at the time, and what I said was that we had not in fact reached any final agreements with, and this is one of the problems that we have have had with General Dynamics. One of the reasons we are withholding their general expense billings and payments today and have been since early March was that they have not closed out their billings with us and their disputes with us.

In that sense, and that was what I said, was that we had not reached any agreement and in that sense paid their bills, and in fact, now today, I can tell you that we have in the Department moneys to more than cover, and this is basically as a result of withholding payments from General Dynamics over the past 2 months—we have enough money in the Department to cover all of the costs that have been questioned by DCAA's auditors, and in that sense, we hold the money.

Mr. Kasich. The simple fact of the matter is, isn't it true that, in our audit report done by this subcommittee, we have determined that the Pentagon did make payments not only to General Dynamics, but a number of other contractors with costs that were clearly questioned by DCAA where they said we doubt these ought to be allowable; the Pentagon has in fact paid out that money; is that not true?

Mr. Taft. My understanding is that we have in the Department the moneys to cover, more than cover, any unallowable costs that DCAA has questioned. I have instructed them to get into that position, and I was advised 2 weeks ago that we were in that position.

Mr. Kasich. The simple fact of the matter is that my constituents know that we have in fact paid contractors for overhead costs that included some portion of things like boarding a dog at a kennel, and employee cafeterias, and first-class air travel to the tune of about $2.5 million on the use of private corporate jets, which DCAA objected to, but yet the Pentagon paid.

I have been complimentary to some people in the Pentagon for aggressive action, but this sounds like spare parts all over again. The Pentagon says, "We have spare parts under control." Yes, once the Congress put the pressure on the Pentagon and particularly this subcommittee put the pressure on the Pentagon to clear it up. I wish the Pentagon would say, "We made a mistake, but we are moving aggressively to try to change it." I still don't hear that.

This morning we are in a battle of whether in fact you paid the costs; you did. Something that bothers me as much as the $18 billion, from a CBO report in April 1985, points out that the procurement section of the budget has risen to an all-time high.

It says in the report, and I would like Mr. Taft to comment:

> A significant share of the increase in procurement funding authorized since 1980 also went to fund unanticipated higher prices, not increased quantities or qualities of equipment. DOD's original plan for 1981 to 1985 anticipated that prices would decline over time as cumulative production increased. Actual costs per unit for certain major weapons were higher than expected by percentages varying from nine percent to sixty-four percent during the 1981 to 1985 period. These higher costs were recognized in the 1983 budget submission. Since then, costs per unit have remained relatively stable. Nonetheless, over the period 1981 to 1985, unanticipated cost increases did consume a substantial part of the growth in procurement funding.

The report says that per unit costs went up. The quantity did not significantly increase, nor did the quality. What disturbs me, as someone who has voted for these budgets, is how can we have a Congressional Budget Office study that says we aren't getting what we paid for? I would like you to answer that specifically, Mr. Taft, and to please put this report at rest if it is, in fact, possible.

Mr. **Taft**. I am not familiar with that particular report. I can say that we have in the Department some weapon systems that have had cost increases. We have, I am delighted to say, some weapon systems that have had cost decreases. The fact of the matter is that if you net out what was anticipated in 1981 as to be the cost of the defense program that we submitted then on the Department's side, the program has been bought for less money than we anticipated.

I should say also that as far as the CBO is concerned, and really I guess you ought to ask them about their report, but if we had taken their assumptions in 1981, they would have been even further off.

The CBO in 1981 predicted that our program would cost more than we thought it would and the record is very clear on that. There was a fellow who got on the cover of Time magazine for saying that we had underestimated the cost of our program. Well, they are all wrong. We have actually got the program in for less money overall.

Now, that is not to say that each particular weapon system has been less. Some have been more, some have been less, but on net, the result is billions of dollars less than anybody predicted would be the case and the CBO was on the high end of the predictors.

Mr. **Kasich**. I have just a followup question to this. I want to make this clear because I think this is very important.

I would like you to check it and submit it to my office and to the committee, Mr. Taft. And I would ask you to check this report, the Congressional Budget Office, defense spending, what has been accomplished, with the most massive buildup in peacetime history. It says actual costs per unit for certain major weapons were higher than expected by percentages varying from 9 percent to 64 percent during the 1981 to 1985 period, and that in fact to talk about the overall buildup in procurement, it simply says that a significant share of the increase in procurement funding authorized since 1980 went to fund unanticipated higher prices, not increased quantities or quality of equipment.

What they clearly say is that your costs are going up for weapons systems, not coming down, and as the units have gone up, the costs have gone up. When I look at the charts and see what the various weapon systems have done, it is not my responsibility to ask CBO. They have already given their report.

I want to know what you, the No. 2 guy in the DOD, says about F-15 aircraft going up 25 percent, C-5B transports going up 25 percent. I want to know why that is happening and why the CBO says this; because if what they say is true, it means we are not getting what we paid for, and that is as disturbing as the $18 billion that we have found.

Mr. Chairman, I would like to see that submitted when Mr. Taft has an opportunity to review this.

Mr. **Taft**. We will submit it.

[The following information was received for the record:]

INCREASE IN F-15 AND C-5B UNIT COSTS

The data shown in the referenced CBO report is basically correct. However, the methodology used to generate that data does cause some distortion; e.g., deescalating the FY81-FY85 data to FY81 dollars using the FY81 President's Budget (PB) rates and then inflating from FY81 dollars to FY85 dollars using FY86 PB rates does not account for the fact that the FY80 and FY81 inflation rates were adjusted later from the 8.6% and 9.0% used when the FY81 PB was submitted to 9.7% and 11.9% respectively. This increase impacts the actual data for FY81-FY85. A similar situation exists for the FY83-FY85 data since the rate for FY83 changed from 8.5% to 9.0%.

Apparently the analysis has not considered the impact of advance procurement funding over the period analyzed. If debits exceed credits, the unit costs are overstated since some of the funding is for future units. If debits are less than credits, the unit costs are understated. As an example, based on our calculations, this would change the C-5B unit cost growth from the 25% shown to 23%. Regardless of this adjustment, the increase in unit cost for the C-5B is due largely to the decrease in quantities. Quantities decreased by 46% from 24 to 13 during the period analyzed.

Similarly the 25% increase in unit cost for the F-15 during FY83-FY85 using the FY83 PB as the baseline is associated with the decrease in quantity by 41%.

The increase in F-15 unit cost during FY81-FY85 using the FY81 PB baseline is a result of a significant change in the program content. Quantity increased from a planned total of 90 to 195; however, the FY81 PB program had a planned production termination in FY83. The extension of production and significant increase in quantities generated an immediate requirement for increased support funding. In addition, initiation of the F-15 MSIP program and configuration changes funded during the period analyzed increased the cost of the aircraft and support for the actual data compared to the FY81 PB.

Mr. TAFT. Let me speak to the weapon systems, the F-15 and the C-5. This committee investigated the C-5B contract when it was let. We were charged at that time with overestimating the cost of it. We returned last year some $400 million on that account to the taxpayers that doesn't have to be spent. That program is coming in at less than was predicted for it when it was authorized in 1982.

The F-15, when I last checked, had a unit cost increase of about 1 percent over the last 5 years, which I think is basically within the margin of error, and not a substantial increase.

We will comment on the entire report. This committee is very familiar with the C-5B and that has been a great success story for us. The plane is a lot less expensive than this committee, which looked at it in enormous detail, ever dreamed it would be.

Mr. NICHOLS. Mr. Spratt.

Mr. SPRATT. Thank you, Mr. Chairman.

Mr. Taft, I have been looking through the proposed bill and also looking through your testimony. I don't really find any instances where you have cited provisions that would put you in an inflexible straitjacket.

Can you point to some that would straitjacket you to—that you didn't have the freedom to revise and reinterpret and promulgate new and different regulations within these parameters from time to time? Which provisions in particular? This seems to be a very generalized bill.

Mr. TAFT. I would not want to suggest that any one of these—one of the problems is that it is hard to predict. I did show—I think in my testimony I referred to a problem that we had had in the workmen's compensation area and insurance area with the legislation on the Cost Accounting Standards Board. So we have experience which suggests that this can be a problem.

If we knew which ones were going to cause us a problem, then of course we would go to those. And I don't mean to make a big issue of this at all. As I think I indicated, if the committee decides to put these in legislation, we agree with them substantively and it is not going to cause us a great deal of concern.

I think the committee ought to be aware of the history in the past that the inflexibility of the legislative process has caused us some problems. I think the committee simply needs to note that, decide what to do. And, as I indicated, none of these ideas you are asking me—I think they are all good, and that is what I have said. We support them substantively.

We may be wrong. That is about all I can say.

Mr. SPRATT. I understood you to say you support the concept of a penalty and believe that it should be statutorily based.

Mr. TAFT. We do. I believe that penalties are much better established by legislation. We could run into constitutional problems later on. This would clarify it and be very useful.

Mr. SPRATT. On May 7, GAO recommended to Mr. Weinberger that allowable costs be itemized in the negotiations not completed on a bottom line basis, traded out in terms of dollars, but significantly itemized at the outset.

Mr. Math, who will testify shortly, will further support that position.

Do you also accept that recommendation?

Mr. TAFT. We do. We think that is a good recommendation, and we should do that.

Mr. SPRATT. How would you comment on an amendment to this bill that would give the DCAA subpoena power to subpoena records of contractors who might support their claims for reimbursement costs?

Mr. TAFT. I would support that and recommend that it be lodged; that authority be lodged in the Director of the DCAA. As you know, the Inspector General of the Department currently has subpoena authority. The DCAA Director now can go to him and recommend that the inspector general use his subpoena authority. That has been challenged. I think it would be good to give authority to the Director of the DCAA to issue subpoenas on his own behalf.

Mr. SPRATT. You would support the idea of, No. 1, giving the expressed subpoena power to the DCAA; and, No. 2, putting the warranting authority for the subpoenas in the Director of the DCAA?

Mr. TAFT. I think so, yes. The only reason I want to—I don't want to sound at all critical about our auditors, who I think do a very good job. And I think this committee has seen that they do do that. But a subpoena is a serious thing, and I would lodge it at the level of the Director; require them at least to go to him.

Mr. SPRATT. We had some testimony from Mr. Cofer last week, and we have testimony today from the witness from GAO, to the effect that contracting officers have overruled DCAA. Would you comment on this?

And, to what extent are you giving support to DCAA in its efforts to enforce disallowable costs?

Mr. TAFT. The DCAA auditor, as you know, in the largest number of cases is in fact the person who allows or disallows the costs that they audit. In a number of contractors—and I think it is 400, our 400 largest contractors—that the contracting officer has that authority, and occasionally disagrees with the auditor. I am not in a position to tell you, and I don't think anybody is, actually, that the auditor is always right; that he should never be overruled.

My guess is that, like most of us, they make mistakes from time to time. So the contracting officer may be right in overruling them, if that is what he does.

The important thing, I think, is not who makes the decision but that the auditor's position before it is overruled should be very carefully reviewed and given respect, and there ought to be a very good reason for overruling it. I wouldn't say that it should never be overruled, but it ought to be thought about. And we have tried, and we have written directives to our contracting officers to that effect. There are a great many of them, and I hope that they are all doing the same thing and allowing the right costs, disallowing the wrong costs. And we certainly have instructed them to do that.

Mr. SPRATT. Thank you.

Mr. NICHOLS. Mr. McCloskey.

Mr. McCLOSKEY. Thank you, Mr. Chairman.

Mr. Taft, with regard to the penalty area, which you agree is appropriate for legislation, are these penalties enough, in effect, a fine or whatever, of twice the disallowed cost? Some people would consider that a fairly moderate sanction. I would like to hear your response.

Mr. TAFT. I would want to defer to the committee's judgment on that.

I will say I have been disappointed in some situations that I have seen where an error has come in, and it might be only $10,000 or $15,000, and even if you are triple or 10 times that, in a penalty it is not a very substantial amount for what might be a blatant act, although not involving a lot of money. So I would say it might be as well to set a floor, say as in the criminal statute, of $10,000 or $50,000 or something like that, rather than have it related to the amount, because the blatancy of the act is often separate from the amount involved.

Mr. McCLOSKEY. Your own subjective, then informed, opinion of the problems in this area, are there more than very, very rare cases in which a real aspect of fraud would arise where you feel that more severe sanctions could or should be considered?

Mr. TAFT. Well, we are talking about things that I assume are short of the criminal law, which has of course different sanctions for violations. But I would like to see the authority for civil sanctions, which are more flexible than criminal ones, expanded.

Mr. McCLOSKEY. What kind of a position does it place you and your department in when one of the contractors refuses to supply supporting documents? I am interested in the subpoena power. I can't believe that someone in good faith doing business with the Government would refuse cooperation with the auditors. It would seem that is a real problem for your appropriate administration there.

Mr. TAFT. It is, and we have some cases that are not satisfactory from our point of view. I will tell you that we are litigating one in Pittsburgh now. Ultimately, we are like anybody else, like this committee, and we have to go to the courts to enforce our subpoenas. That can take more time than we like. And when we think we are absolutely right, it is frustrating.

Mr. McCloskey. Have you had any positive replies from industrial firms or professional associations as to ways, as you have suggested, that the industry can and should improve in this area?

Mr. Taft. We have had a number of suggestions, and I will be glad to share them with the committee.

I have had—in response to my letter that I sent out on the 31st of December, I have gotten quite a lot of responses in, and I would be glad to make those part of the record for you.

Mr. McCloskey. We would be very interested in those.

[The following information was received for the record:]

The Deputy Secretary of Defense,
Washington, DC, December 31, 1984.

Mr. Edward L. Hennessy, Jr.,
Chairman and Chief Executive Officer, Allied Corp., Morristown, NJ.

Dear Mr. Hennessy: I have set an objective for the Department of Defense to achieve significant and tangible reductions in contract overhead costs. While I recognize that cost reduction initiatives should not lose sight of total price, much can be gained from addressing the large cost components of contract price like overhead. Typically, these costs have represented roughly a third of the price we pay for weapon systems.

One way of meeting this objective is to improve the Government's own oversight of contractor overhead management. I have already begun specific initiatives that will find better application of existing tools, as well as create new ones. These initiatives are designed to assure that our contracting officers negotiate prices that reflect a greater degree of cost efficiency. Another way to improve overhead cost control is to enlist the active participation of individual defense contractors. This is absolutely essential because the contractor has the responsibility for overhead management. I am, therefore, asking the Chief Executive Officers of major defense contractors to establish meaningful overhead cost reduction programs.

I am fully committed to obtaining significant and tangible reductions. To this end, I have established the ten principles of overhead cost control shown in the attachment. These principles will set the tone for our program, as well as provide a framework for further initiatives. I am also willing to develop incentives to give defense contractors an inducement to cut overhead costs voluntarily, where incentives are necessary to produce the results we are trying to achieve. I would welcome any ideas that you might have.

Sincerely,

William H. Taft IV.

Attachment.

ALLIED

Allied Corporation
1000 Wilson Boulevard
Arlington, Virginia 22209

1985 JAN 24 PM 4:04

OFFICE OF
THE SECRETARY OF DEFENSE

William C. Purple
Executive Vice President
President — Bendix Aerospace Sector

16 January 1985

William H. Taft, IV
Deputy Secretary of Defense
The Pentagon
Washington, D.C. 20301

Dear Secretary Taft:

As the individual primarily responsible for Allied's aerospace business, Mr. Hennessy has referred your letter of 31 December 1984, setting forth your principles on overhead cost control, to me for consideration.

We have been committed to overhead cost control for a long time as a normal function of doing business. For example, we review detailed overhead costs as a percentage of sales in order to detect unacceptable trends. Also, periodic overhead census reduction programs have been initiated when appropriate, especially in areas of administration, finance, human resources, etc., even though overall sales are projected to increase. Additionally, we are spending at least $50 million over a five year period to relocate product lines for lower cost labor and reduced fringe benefits. Recently, our insurance program was revised to require greater contributions by our salaried employees, with a resulting reduction in projected costs for our corporation.

These actions on our part are not short-term reactions, but rather on-going programs to maintain a healthy and competitive business posture. During 1984, a survey of readers of Aviation Week and Space Technology conducted on our behalf and without respondents knowing who requested the survey, showed that the Bendix Aerospace Sector of Allied Corporation was considered a low-cost supplier by both our peers and our customers.

We welcome your initiatives to reduce defense costs and will continue to support you in this program; however, we must work together to ensure that any new initiatives are truly cost-effective and do not result in additional reporting and government interfacing which in turn causes us to increase our overhead staffing. If we detect any such increase as a consequence of new initiatives, we will alert you to them.

We are proud to be a member of the defense industry team and to join you in the common goal of getting the best defense for the country in the most economical manner.

Sincerely,

Bill [illegible]

1985 MAY -2 AM 10: 04
THE SECRETARY OF DEFENSE

AVCO CORPORATION

DONALD E. FARRAR
PRESIDENT

April 23, 1985

The Honorable William H. Taft, IV
Deputy Secretary of Defense
Washington DC, 20301

Dear Mr. Taft:

I am writing to formally follow up what my staff has conveyed to your department regarding Avco's continuous overhead cost reduction program. At Avco cost minimization is an ongoing process that is an active and integral part of each operation. However, in response to your stated objective of December 31, 1984, I have directed the consolidation of our ongoing efforts into a program as outlined below.

At my direction, Avco has assembled a task force to monitor a consolidated overhead cost program. The task force has been pulled together to identify areas of significant dollar overhead to be reviewed with the intention of obtaining meaningful monitorization in order to take advantage of any cost reduction opportunities. Some cost areas identified by the task force are health care, pension, energy, traffic, supplies and indirect personnel. In addition to identifying and monitoring such costs, the task force has developed a quarterly reporting system for this initiative. The quarterly reports will be evaluated for actual benefits resulting in a savings to the company (and ultimately our customers).

If I can be of further assistance, please let me know.

Sincerely,

Donald Farrar

1275 KING STREET, GREENWICH, CT. 06830 · (203) 531-2800

1985 FEB 13 PM 2:17
OFFICE OF
THE SECRETARY OF DEFENSE

THE BOEING COMPANY
SEATTLE, WASHINGTON 98124

T. A. WILSON
CHAIRMAN OF THE BOARD

February 4, 1985

Dear Secretary Taft:

In your letter of 31 December 1984 you request the CEOs of major defense contractors to establish meaningful overhead cost reduction programs to help achieve your objective of significant and tangible reductions in contract overhead costs.

Even though over 60% of our sales are normally to commercial customers, Boeing operates as an integrated company. Our operating and central services segments work together to put all of our facilities and people to optimum use in performing our contracts. Every part of our business is highly competitive. We realize that to survive and grow in both military and commercial markets, we must constantly continue to develop and produce consistently higher quality, technically superior and more cost effective products.

In pursuit of these objectives, Boeing recently initiated Operation Eagle, Company-wide. Operation Eagle is aimed at greatly increasing the participation of each employee and supplier in striving to meet "tougher, more aggressive cost reduction and quality improvement goals than we have ever had in the past." This is an "umbrella" program concerned with enhancing the effectiveness of our many continuous cost reduction and quality improvement programs. It recognizes overhead reduction as a major part of the total effort. I have attached a newly-distributed brochure aimed at enlisting everyone as a contributor to Operation Eagle.

The statement of principles attached to your letter emphasizes actions to be taken by Government people to effect contract overhead cost reduction. In our view, there is significant potential for contract overhead cost improvement in the elimination and reduction of non-product, non-technical requirements. In the recent past, Boeing developed and proposed many such specific changes and offered corresponding contract price reductions. Although the eventual result fell short of our expectations, the effort was valuable in showing in a specific weapon system procurement the large scope and high cost of unproductive work and reporting required by well-intentioned laws, regulations and policies and the tough job of eliminating or reducing these requirements.

FEB 13 1985
DEP SEC HAS SEEN
See Mr. Taft's comment

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Do we have these
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Certain of the principles suggest or could require actions by Government or contractors which are novel and raise questions that seem worthy of note. These items are set forth in an attachment to this letter for your further consideration.

We would be happy to brief you on Operation Eagle and on our efforts to eliminate contract requirements to our mutual benefit.

Yes -

Sincerely,

T. A. Wilson

T. A. Wilson

Attachments: (2)

The Honorable William H. Taft, IV
Deputy Secretary of Defense
Washington, D.C. 20301

Attachment to T.A. Wilson letter
to DepSecDef W. H. Taft

COMMENTS ON PRINCIPLES OF OVERHEAD COST CONTROL

The coverage and contents of the ten principles soundly place emphasis on cost prevention and avoidance and on thorough review and analysis of operations and requirements to provide a base of knowledge and information in support of price negotiations. Several of the principles, however, could be viewed by some as requiring actions on both sides which could lead to disagreement and impair attaining common objectives.

The principle on Business Base suggests that business volume forecasts be certified as cost or pricing data. The pricing certificate required by Public Law and the FAR should not be used to cover any estimates or judgmental data, as the regulations point out. However, factual information with respect to anticipated business volume is required to be furnished and certified, at the time of agreement on negotiated contract prices. The continued observance of this necessary distinction is vital to the business relationships of DOD and its contractors.

The principle on Team Approach stresses the importance of the Contracting Officer and his advisors maintaining effective communication with program management, the buying office and the contract auditors, so that the team members participate in all aspects of overhead cost control. We believe this to be extremely important so we don't lose sight of our common objective which is to reduce total unit costs.

The principle on Accounting Systems urges that Government officials fully understand the contractor's management accounting as it relates to overhead planning and control. Planning and controlling overhead costs is the contractor's job; it cannot and should not be approached as a joint effort. It is important that a clear separation be maintained between Government management of its contract pricing and surveillance functions and contractor management of its contract planning, performance and other business functions.

1985 FEB 11 PM 4:48
OFFICE OF THE SECRETARY OF DEFENSE

See Mr. Taft's comment
[illegible] 1985
DEP SEC HAS SEEN

E-SYSTEMS

John W. Dixon
Chairman of the Board
and Chief Executive Officer

D:
We need a substantive reply –
WHT

4 February 1985

The Honorable William H. Taft, IV
Deputy Secretary of Defense
The Pentagon
Washington, D.C. 20301

Dear Mr. Taft:

You and I share the common goal that our nation be postured with an adequate defense capability obtained in the most cost effective manner as you addressed in your letter of 31 December 1984. I outlined to my Board of Directors as recent as our 19 December 1984 meeting, a program that would emanate from my office as Chairman and Chief Executive Officer, that throughout E-Systems we would reemphasize a strong direction toward a more effective "Cost Conscience" attitude in 1985 and beyond. I have disseminated this plan, entitled E-Systems Cost Reduction/Avoidance Program, throughout the company and it will be among my top priorities for 1985.

Your ten Principles of Overhead Cost Control, however, give me some concern in that they seem to say that you intend to control overhead costs by expanding DOD's oversight of internal contractor management and operations. In my opinion, most of the provisions contained in your Principles of Overhead Cost Control now exist in one form or another with existing government organizations charged with their implementation. This very considered opinion is based on thirty years of defense industry experience of which the last one-half has been as Chairman and Chief Executive Officer of a major defense electronics contractor. More controls will only involve additional staffing in government with an appropriate ratio of added industry staffing, all of which operate to increase overhead cost rather than decrease it. So perhaps government and industry should, with understanding and diligence, join together to fine tune only if and as necessary the existing framework of weapon cost control systems. I fear that the inevitable result

CORPORATE OFFICES
POST OFFICE BOX 226030 • DALLAS, TEXAS 75266 • (214) 661-1000

will be added audit surveillance which will interfere with our ability to operate efficiently. I submit, Mr. Taft, that the profit motive combined with the added emphasis on competition provides adequate incentive for overhead cost control without any added DOD management by audit.

I would encourage you to solicit from the private defense industry sector, on an individual company basis, a commitment toward a voluntary and self-developed cost reduction/avoidance plan and "cost conscience state of mind" that is particularly suited to the nature of the respective company's individual defense business and corporate environment, just as I have inaugurated at E-Systems. I am enclosing a copy of my presentation to my Board of Directors of E-Systems Cost Reduction/Avoidance Program.

Sincerely,

John W. Dixon

John W. Dixon
Chairman and
Chief Executive Officer

BOARD OF DIRECTORS MEETING
19 December 1984

E-SYSTEMS COST REDUCTION/AVOIDANCE PROGRAM
"Cost Conscience Attitude For 1985 and Beyond"

During the past ten years at E-Systems, one of our major goals has been controlled growth. We have increased our sales from aproximately $200 million to $800 million. Now is the time for our mature company to place added emphasis on a more effective cost reduction/avoidance program in 1985 and beyond. I plan for E-Systems to set the trend and be the national leader in this worthwhile endeavor.

Being the leader is not new to E-Systems--U. S. Government Savings Bonds, ESOP, and Number One Fortune Five Hundred Company on Return to Stockholders are some of our outstanding national accomplishments. We have always prided ourselves in being one of the nation's leaders as a cost effective, quality, and efficient contractor for the Department of Defense and other customers. I plan to reemphasize in the strongest of terms, plans, actions, and goals relative to 1985 and beyond, which will ensure that the Defense Department and other customers will receive from E-Systems the most effective mission and cost-wise systems and products that can possibly emerge from the technical, management and production minds, skills and plants of E-Systems.

Cost reduction is the saving in material, labor and overheads through improved processes, techniques, procedures, or management without sacrificing required quality, reliability, or schedule. Programs in value engineering, substituting capital equipment for labor, make or buy decisions, material conservation, work simplication, employee suggestions, and other collective or individual efforts will be encouraged at all E-Systems locations and at all organizational levels.

This "Cost Conscience" state of mind is part of E-Systems "leaner and meaner" attitude that all 12,000 of us E-Teamers must have. We will not, however, mortgage the future of E-Systems by permitting tempting short-term decisions that would jeopardize the building of long-term values of the company to the detriment of our customers, shareholders and employees. Shrewd judgement must be exercised on any cost reduction/avoidance goal. However, we must take an aggressive approach to each line item in our company budget in both direct and indirect categories.

With all 12,000 E-Teamers actively involved, the effectiveness of this Cost Reduction/Avoidance Program will be greater. I plan to implement the program as follows:

- January 1985 - I will send a letter to each General Manager and Corporate officer directing that he set up an effective division-wide or staff function cost reduction/avoidance program.
- February 1985
    - I will include this important program in my annual "Management Overview" message to our Division Management Club Members.
    - I will require a report of program development and implementation status at the Plans and Operations Meetings by each division General Manager each month in the future.
- April 1985 - Written quarterly Executive Summary Reports will begin by each division General Manager at this P & O Meeting and will include status of goals and accomplishments during the first quarter of the year. Future quarterly reports will be presented at the end of each quarter in April, July, October, and January.

I am going to direct that each Corporate Staff Member implement an effective cost reduction program and report quarterly on their cost reduction/avoidance goals and accomplishments at my Corporate staff meetings.

This program is going to be launched from my office as Chairman and Chief Executive Officer and will reach all levels of management and employees where so many of the cost reduction ideas are bound to develop.

All of our employees are vitally interested and dedicated to supplying our customers with the "best" as a matter of course. However, I envision the possibility of some sort of division and employee recognition for outstanding contributions to this program.

So in summary, we have developed a plan; we will establish objectives; responsibility, and accountability have been assigned; effective methods of communicating this program to all employees will be developed; and I am examining alternatives of recognizing divisions and employees for outstanding contributions to this most important cost reduction /avoidance program.

John W. Dixon

1985 MAR -7 AM 11: 07
OFFICE OF
THE SECRETARY OF DEFENSE

Robert H Malott
Chairman of the Board and
Chief Executive Officer

FMC Corporation
200 East Randolph Drive
Chicago Illinois 60601

February 28, 1985

Honorable William H. Taft, IV
The Deputy Secretary of Defense
Department of Defense
Washington, D.C. 20301

Dear Secretary Taft:

We welcome the opportunity to discuss ways of reducing overhead and other contract costs such as those outlined in your letter of December 31.

Cost control has long been a top priority at FMC. Examples of our success in controlling costs include the continually declining cost of the Bradley Fighting Vehicle and the recent 22% reduction in the unit price of the Mk 45 5" gun mount.

We have been able to achieve these savings by controlling both direct and overhead expenses and by investing in new techniques to increase productivity, such as robotics, Computer Integrated Manufacturing, and Just In Time Inventory practices. Although some of these techniques have increased our overhead costs, they have actually lowered total product prices by reducing direct expenses.

Based on our experience, we believe it is essential to consider the total cost of a system when evaluating any cost reduction measure. In this regard, I support your proposal to create "contractor incentives" to reduce overhead costs, but am concerned that other proposals aimed at monitring defense contractors may, in fact, be counterproductive to your overall cost control effort.

For instance, recent proposals by the DCAA to gain greater "access to records," such as motivational budgets and internal audits, and to increase the number of auditors could significantly increase the cost structure of a project since contractors must employ additional overhead personnel to work with each auditor.

Another proposal by the DCAA recommends that salary increases above a certain level to defense contractor personnel no longer be treated as "allowable costs" in government contracts. However, as I'm sure you realize, contractors cannot expect to attract or retain good people unless they pay salaries that are fully competitive with commercial businesses.

FMC Corporation shares your concern about the need to reduce unnecessary costs and would be pleased to discuss ways that defense contractors could contribute to this important endeavor.

Sincerely,

Robert H. Malott

1985 FEB 13 PM 1:06

OFFICE OF
THE SECRETARY OF DEFENSE

Donald E. Petersen
Chairman of the Board

Ford Motor Company
The American Road
P.O. Box 1899
Dearborn, Michigan 48121-1899

February 4, 1985

The Honorable William H. Taft IV
Deputy Secretary of Defense
The Pentagon
Washington, D. C. 20301

Dear Mr. Taft:

I appreciate receiving your December 31 letter on contract overhead costs. We at Ford support all efforts to reduce any excess costs being incurred to provide a strong defense. Such reductions will assist greatly in providing the defense of the nation concurrently with reducing the deficit.

In our Company, we have an extensive program to enhance our competitive position in the United States. Mr. Caldwell outlined this program to Mr. Carlucci on December 31, 1981 (copy attached) in response to his initiatives to improve the procurement process. Since 1981, our program has proceeded as planned, with total cost reductions now achieved of $4.5 billion. We are continuing our efforts throughout the Company to eliminate inefficiencies and excess operating costs. We have concluded that it is important to concentrate on a balanced improvement in costs, without undue emphasis on any single cost element.

We believe that the best incentive to reduce costs for defense contractors -- and any other business enterprise -- is the additional business and profits that can be earned by the most efficient producer. With existing programs to contain and reduce our overhead costs, we expect to be as efficient as or more efficient than other government contractors. We believe that additional incentives are not required to produce the results that you are trying to achieve.

We have some concern that an undue emphasis on reductions in a particular cost element, such as overhead, could provide the wrong incentives for reduction of total costs. One method of reducing total costs involves increased use of automation, both in the plant and in the office. This automation requires an increase in investment in systems people, machines, computers, and word processors. These changes will increase overhead while reducing direct labor and the total cost of doing business. An undue emphasis on overhead also could increase the difficulties in allocation of direct labor hours. In some recent Government audits, the Defense Contract Audit Agency recommended that additional direct labor personnel be reclassified to indirect labor because of the difficulties in allocation of time. For example, certain parts crib attendants were required to charge time to over 20 contracts.

In our automotive relations with suppliers, we have found that reduced procurement costs can be best achieved by working together with trust and emphasis on a long-term relationship. Once we have selected a supplier who provides good quality with competitive prices, we build on that relationship for the benefit of both Ford and the supplier. We are concerned that recent U.S. Government actions appear to be creating an adversarial relationship between the Government and its suppliers. This recent emphasis could result in an increased cost of procurement for the Government because overhead costs will be added by both the Government and the contractors to be responsive and adequately protected. Further, it will reduce the number of contractors willing to do business with the Defense Department.

We believe it would be desirable for the Department of Defense to compare its procurement policies with the practices of commercial companies. Most commercial companies have substantially fewer regulations and specifications to purchase goods and services. The recent deregulations of the airline and telephone industries have shown the benefits of a less managed environment. We believe that the largest contribution to reduced overhead cost of the Defense Department and the contractors could be achieved by deregulation. In his letter to Mr. Carlucci, Mr. Caldwell recommended reductions in DoD administrative requirements. He noted that DoD has 100 times as many auditors per dollar of purchases as Ford. Since 1981, the Government has added the Inspector General's Office, with the audit function expanded rather than reduced.

Thank you for the opportunity to provide some suggestions that may be helpful in your efforts to improve efficiency in the Department of Defense.

Sincerely,

Donald E. Petersen

Donald E. Petersen

Attachment

GTE

1985 FEB 12 PM 3 52
OFFICE OF
THE SECRETARY OF DEFENSE

Harold E. Patterson
President

GTE Government Systems Corporation
100 First Avenue
Waltham, MA 02254
(617) 466-3501

6 February 1985

The Honorable William H. Taft, IV
Deputy of Secretary of Defense
Pentagon
Washington, D.C. 20301

Dear Sir:

Your letter of 31 December 1984 to Mr. Theodore Brophy on the subject of overhead control strikes a responsive chord at GTE. As a large corporation operating in multiple markets with a diverse customer community which includes the Department of Defense, GTE is most sensitive to the pressures of price competition. Control of the cost of doing business is important to meeting that pressure and is a major item on the management agenda of GTE in both its commercial and government business entities.

At GTE Government Systems Corporation, we have an ongoing pogram at all our divisions to monitor and control all areas of contract cost and operating efficiency. Overhead expense is one of those cost areas. Division managers report directly to me on the progress of their programs. While I feel we are doing a good job in this area, there is always room for improvement, and I welcome your initiatives on this subject.

GTE will, as always, work with representatives of the various government contracting and audit agencies in support of your program. In the meantime, as a member of the National Security Industrial Association, we have joined with other companies in the preparation of a detailed response to your letter that will address specific areas of suggested emphasis.

For its part, GTE is a corporation proud of its contributions to the national defense and will continue to strive to offer its products and services to the government at fair and reasonable prices.

Sincerely,

HEP/c

cc: Mr. Theodore F. Brophy
Chairman & Chief Executive Officer
GTE Corporation
One Stamford Forum
Stamford, CT 06904

Mr. Allan L. Rayfield
President
GTE Diversified Products
One Stamford Forum
Stamford, CT 06904

1985 FEB 13 AM 11: 13
OFFICE OF
THE SECRETARY OF DEFENSE

GENERAL DYNAMICS CORPORATION
Pierre Laclede Center
St. Louis, Missouri 63105

David S. Lewis
Chairman and Chief Executive Officer

314-889-8234

5 February 1985

The Honorable William H. Taft, IV
Deputy Secretary of Defense
Washington, D.C. 20301

Dear Mr. Secretary,

I support your new initiative to establish meaningful overhead cost reduction programs. We are acutely aware of the impact of overhead on the total cost of our products and, as a corporation, consistently strive to reduce our total product cost. I initiated a forceful internal program to reduce costs in a memorandum dated 10 December 1980 to our general managers and corporate staff. My memorandum was in response to preliminary operating plan data in which overhead costs were projected to increase. An extract from my memorandum follows:

> "Over the past year, everyone receiving a copy of this memorandum has been urged to give his personal attention to the continuingly serious requirements to reduce direct and indirect costs..."
>
> "On 2 December 1980, I reviewed the preliminary 1981 divisional operating plans and it was very disappointing to see that, almost without exception, the divisions plan to continue to operate on a 'business as usual' basis."

With this memorandum, I initiated a corporate-wide effort under the direction of our President, Oliver Boileau, to review each operation with the determination to improve total cost performance. I directed the following:

- "...a capable team will go into each major division and spend as much time as necessary, digging into the various plans and accounts that are key to reducing direct and indirect costs. They will do everything they can to find areas where misguided management discretion or inattention are insuring unnecessarily high costs and where better practices can have a significant impact."

In January 1981, a special team began periodic reviews of overhead expenses and these reviews were repeated semi-annually for two years until all action items had been satisfied and no new action items were issued. In 1983, under the direction of Dr. Alan Lovelace, Corporate Vice President - Productivity and Quality Assurance, a corporate-wide productivity/quality improvement program was initiated to expand and carry forward the efforts which I directed in 1980.

Since 1980, the total factory direct labor hours required to build an F-16 aircraft have been reduced from 50,000 hours to 32,000 hours today. Since taking over the M1 Program from Chrysler, the factory hours have been reduced from 9,400 hours per tank to 6,400 hours per tank. At the same time, our quality improved and the production rate doubled. Accompanying these and other direct cost reductions was a reduction in the ratio of indirect employees to direct employees.

Recently, the corporate direction for the preparation of 1985 Operating Plans stressed the need to invest to improve the control of overhead costs:

> "...increase the productivity of employees... by making cost effective investments in equipment..."
>
> "Review and upgrade management information systems as necessary to enhance performance measurement and reporting."

Carrying through on the thrust of the last four years and in support of your latest initiative, I have directed our Vice President and Controller, James J. Cunnane, to establish a new team and a different methodology for review to insure that we take a new look, with new vigor, at every possible opportunity to reduce overhead costs by initiating change in processes, by making capital or systems investments, and by eliminating activities which we can no longer afford. This team will have an on-going responsibility and will report periodically to me with their first report due in March.

General Dynamics has consistently demonstrated its ability to develop and evaluate creative concepts for overhead cost control incentive programs. I will direct Mr. Cunnane to contract your office shortly to insure a close coordination of our joint efforts in this very important area. While we believe General Dynamics has an aggressive program for overhead cost control, we will continue to strive to do better and I pledge to you our continued cooperation in your initiative on overhead cost reduction.

Sincerely,

GENERAL DYNAMICS CORPORATION

David S. Lewis
Chairman

1985 FEB 22 PM 12:45

OFFICE OF
THE SECRETARY OF DEFENSE

GENERAL MOTORS CORPORATION
GENERAL MOTORS BUILDING
DETROIT, MICHIGAN 48202

ROGER B. SMITH
CHAIRMAN

February 14, 1985

The Honorable William H. Taft, IV
Deputy Secretary
Department of Defense
The Pentagon
Washington, D. C. 20301

Dear Mr. Taft:

We at General Motors agree with you on the importance of controlling overhead costs for the Department of Defense. The American automotive industry has in recent years greatly increased its efforts to reduce costs and become internationally competitive, and GM has been in the forefront of this movement. For example, in addition to significant cost reduction moves made during the automotive recession of 1980 to 1982, we also acquired the Electronic Data Systems Corporation (EDS) as a major step toward improving the efficiency of our business.

The acquisition of EDS should have an immediate positive impact on the efficiency of many GM activities. EDS is the recognized world leader in the design of large scale data processing systems and the operation of highly cost effective data centers and communications networks. Merging the EDS and GM communications facilities and personnel will result in an extremely effective worldwide voice and data communications network which will reduce costs. The application of EDS' systems and processing techniques throughout GM will effect some fundamental advances in scheduling, purchasing and manufacturing.

EDS will also assist General Motors new subsidiary, the Saturn Corporation, in approaching the goal of being a paperless car company. The Saturn organization will institute technology and management procedures more advanced than any which exist in the world today. These ideas, of course, have implications far beyond Saturn in that they will be applied throughout GM to improve the efficiency and competitiveness of our plants and products. These efficiencies will also serve to lower the cost of our products and services to the Government.

Another area of cost containment in which we have devoted much effort is employe health insurance. General Motors, together with the UAW, has undertaken in the 1984 labor agreement several measures to help contain these costs. Through the use of innovative approaches, we look forward to making more progress in the future. As further evidence of cost consciousness, the overall labor cost settlement negotiated in 1984 was moderate, thus assuring a slowing down of previous labor rate increases.

One major approach to reducing overhead costs is to spread them over larger sales volumes. The Department of Defense can take advantage of this approach through the use of commercial designs where that is feasible. For example, in 1982 we received a contract from the Army for the Commercial Utility Cargo Vehicle (CUCV). These trucks represent GM's largest military contract since World War II. The CUCV is not a totally new vehicle, but is based upon our commercially-proven, full-size pickup and utility trucks. By adapting this proven design to the tough applications required by the military, the Government is the beneficiary of GM's vast experience and technical expertise in the truck business. Even more importantly, by leveraging its military vehicles off the large commercial sales base of Chevrolet and GMC light-duty trucks, the Government achieves substantial economies that would not otherwise have been possible. Where possible, we encourage this approach by the military.

In relation to the initiative on Contractor Incentives, we feel that there should be more incentives offered by the Government on annually negotiated contracts to encourage contractors to reduce their cost levels while at the same time enabling them to maintain a portion of the resulting benefits. In contracting today, profits resulting from reduced costs are passed on directly to the Government in the form of lower prices.

In conclusion, GM supports the position of reducing overhead costs and is working on reducing costs in many areas in order to be more competitive in the marketplace. Although we have accomplished much, we recognize there is much to be done, and we pledge cooperation with the Department of Defense to attain further cost reductions wherever possible.

Sincerely,

Roger B Smith

1985 JAN 24 PM 4:03
OFFICE OF
THE SECRETARY OF DEFENSE

Grumman Corporation
Bethpage, New York 11714

JOHN C. BIERWIRTH
chairman of the board

January 15, 1985

Honorable William H. Taft, IV
The Deputy Secretary of Defense
Room 3E944, Pentagon
Washington, D. C.   20301

Dear Mr. Secretary:

I thank you very much for your letter of December 31. It seems to me that a review of overhead costs makes a great deal of sense.

I believe that Grumman has always been a company that has kept a pretty firm hand on its overall costs, though we have had a tendency to classify some costs as overhead that other companies consider to be direct.

With our increased emphasis on reducing our costs and improving our competitive posture, it seems to us that the time has come for a rather substantial review of organization structure, as well as the interrelationship of general management people with those in charge of specific operations. We are in midstream of a review, at the moment, that I have hopes I will be able to come down to discuss with you before too long. I would, in any event, appreciate an opportunity to meet you in person.

Sincerely yours,

Jack Bierwirth

1985 JAN 28 PM 5 11
OFFICE OF
THE SECRETARY OF DEFENSE

IBM International Business Machines Corporation

Office of the Chairman of the Board

Armonk, New York 10504

January 17, 1985

The Honorable William H. Taft, IV
Deputy Secretary of Defense
Washington, DC 20301

Dear Mr. Taft:

Thank you for your recent letter. I appreciate your concerns regarding overhead costs. I have forwarded your letter to Mr. V. N. Cook, president of our Federal Systems Division (FSD), since FSD is the IBM focal point for performing custom government contracts.

In FSD, we have focused on total cost structure and the quality and technical leadership of our products and services necessary to ensure our competitiveness in a very demanding marketplace. From a total cost standpoint, overhead costs are important, and we continually work to reduce them, however, all elements of cost must be closely managed and scrutinized.

Overhead expense control and budgeting are key parts of our management and planning systems in FSD. Additionally, we are also heavily involved in improved quality and productivity through the use of quality circles, automated manufacturing lines, information systems designed to increase the productivity of FSD personnel, and a structured program to minimize vendor cost growth. Incentives for cost reductions should be considered; however, cost reductions must be a natural ongoing process in the management of business operations.

FSD is committed to producing the best possible product and service for the government at the lowest possible cost. Effective and tough-minded cost control, coupled with a strategically sound investment program is essential and I pledge our continued support.

Sincerely,

John R. Opel

1985 JAN 24 PM 12: 59
OFFICE OF
THE SECRETARY OF DEFENSE

MARTIN MARIETTA CORPORATION

THOMAS G. POWNALL
CHAIRMAN and CHIEF EXECUTIVE OFFICER

6801 ROCKLEDGE DRIVE
BETHESDA, MARYLAND 20817
TELEPHONE (301) 897-6127

January 14, 1985

The Honorable William H. Taft, IV
Deputy Secretary of Defense
The Pentagon, Room 3E944
Washington, D.C. 20301

Dear Mr. Secretary:

Senior management at Martin Marietta Corporation have met with me to address the subject of your New Year's eve letter on overhead. It will indeed be a better New Year for us all if we can make a significant reduction in our total contract overhead costs. You have my assurance that Martin Marietta is routinely engaged in overhead control; nevertheless, we will address the matter even more aggressively as you have requested. We understand your commitment "to obtaining significant and tangible reductions" and you may be certain that Martin Marietta supports your commitments.

It is our intention to comment to you further at a later date and at that time we will offer any ideas that appear productive.

Respectfully,

Tom Pownall

1985 JAN 28 AM 8 31

OFFICE OF
THE SECRETARY OF DEFENSE

Chairman of the Board and
Chief Executive Officer

22 January 1985

The Honorable William H. Taft, IV
Deputy Secretary of Defense
Washington, D.C., 20301

Dear ~~Mr. Taft~~ Will:

In your letter of 31 December with regard to control of overhead costs, you solicited our reaction and ideas concerning the problem we mutually face and your ten principles of Overhead Cost Control.

I share your observations that cost reduction initiatives must not lose sight of total price. This is particularly critical when the focus is placed on an individual cost element such as those defined under accounting standards as either overhead or direct costs. While I recognize for effective cost reduction action each element of cost needs to be addressed in concrete specific ways, the necessity of segregating costs under accounting standards creates the risk of establishing incentives to reduce one class of costs in a manner that could adversely impact total costs.

As a specific example, the investment of a contractor in capital equipment to improve productivity and quality can well result in the increased overhead costs in the near term through higher charges to depreciation. Care must be taken that in the establishment of incentives, the total cost reduction is kept as the primary focus.

The Administration has recognized this principle through its recent emphasis on competition. No better incentive exists than fair and equitable competition to reduce the government's total ownership costs including the overhead component. Incentives based on meaningful sharing of cost reductions have also proven to be an effective tool in encouragement of cost reduction and should be continued.

Northrop Corporation 1840 Century Park East Los Angeles, California 90067

The current initiative for Industrial Modernization Incentives should be continued. In particular, I would emphasize incentives that encourage contractor investment in facilities with appropriate indemnification terms to mitigate risk where program uncertainties so require.

Northrop has continually emphasized the importance of cost in its approach to the creation of affordable designs with emphasis on high reliability and reduced maintenance manpower. We have also maintained specific programs in our operating centers to improve productivity, quality and cost reduction of both direct and indirect elements. We will continue to stress these programs in response to your request.

Sincerely,

Tom

Thomas V. Jones

1985 JAN 25 PM 2:49
OFFICE OF
THE SECRETARY OF DEFENSE

RAYTHEON COMPANY
LEXINGTON, MASSACHUSETTS 02173

D. BRAINERD HOLMES
PRESIDENT

January 16, 1985

Mr. William H. Taft, IV
Deputy Secretary of Defense
Washington, D. C. 20301

Dear Mr. Taft:

We are pleased to respond to your letter of December 31, 1984, addressed to Mr. Phillips, on the subject of overhead cost control.

Overhead is, of course, a major cost driver in weapons system pricing and as such deserves our continuing attention. The principals cited in the attachment to your letter are indeed the very items which are the basis for Raytheon Company's projection of overhead rates and embody the philisophy we employ in dealing with outside agencies of the government which monitor our performance as well as the direction given to our internal management.

In our own pursuit of balanced cost control between direct and indirect elements, we look very carefully at return as well as investment, for a substantial direct labor reduction may result from a very modest overhead cost. TECH MOD equipment investments are an example of the foregoing which illustrates the interrelationship between two cost elements which, when properly utilized, result in lower product cost. We believe such assessments dictate the need for the application on a continuing basis of prudent management judgements.

While on the subject of overhead, there is one area which we would like to bring to your attention as deserving of DOD level review, and that is the ever increasing number and complexity of sometimes quite redundant studies and surveys being conducted by DOD, DCAA, GAO and the I.G. These various surveillance techniques add measurably to our overhead cost and, just as importantly, drain management attention and often technical talent as well. We do appreciate and understand the need for customer involvement to some extent in our managerial affairs, but coordination of survey activities and consequent elimination of duplication of effort appears to us to be an area which could reap immediate benefit for both parties.

In the attachment hereto we have attempted to address your principles of overhead control in a manner we hope will be informative as well as constructive.

Be assured of our continuing cooperation in your efforts to reduce all cost elements whenever appropriate in the interest of securing the national defense at affordable cost in these fiscally difficult times.

Sincerely,

Brainerd Holmes

attachment

Comments on Deputy Secretary Taft's Overhead Principles

Prospective Pricing, Business Base and Continuous Evaluation

Raytheon utilizes a highly structured formal business planning and forecasting system which forms the foundations for all budgeting activities. Under this system each operating entity prepares both a near-in (i.e., one year) and long range (five year) forecast of expected order receipts and sales, personnel requirements, facilities requirements and other business factors. These projections are based upon known contracts in-house, expected annual follow-on procurements for existing programs and reasonable expectations for new awards. We are in complete agreement with the need for prospective pricing and pursue forward pricing rate agreements with the Government at all operations performing under Government contracts. We also pursue the negotiation of advance agreements in selected areas where appropriate. Forward pricing rates are prepared in detail based on these plans by individual location and negotiated with the resident DCASPRO/DCAA team. Our forward pricing projections are reviewed periodically and adjusted as anticipated business prospects fail to materialize or unexpected orders develop. We work closely with the Government in its efforts to maintain ongoing evaluation of forward pricing projections.

While it would be most advantageous for any contractor to know for sure what order receipts he could count on for forward pricing projections, unfortunately even the best projections can be upset by Congressional delays, program reductions, funding problems, etc. Projections can never be more than estimates. We believe that the detail support provided for in our projections, combined with the practice of updating rates at periodic intervals provides a realistic and reasonable method of estimating future overhead expense.

Discrete Cost Analysis

Our proposals are based upon the latest information available and carefully screened by resident

DCAS and DCAA personnel. These personnel also perform continual operational audits at all our Government business facilities. In addition the company's internal audit staff also reviews practices for conformance to procedures and identification of areas which could be improved. The company requires annual zero base budget preparation based on anticipated requirements as opposed to prior history. Each department must submit an annual budget which ties into the business plan for the current year and is not tied to existing work force or space occupied.

Personnel Costs

Raytheon Company has a long standing practice of establishing competitive compensation plans which have enabled the company to attract and retain a highly competent work force. These plans have reflected our desire to compensate employees fairly with respect to external comparison and to preserve internal equity. Our benefit programs are comprehensive and consistent with industry practice. They are geared to attract, retain, and motivate employees to attain and sustain an effective and efficient work force. We believe we have followed a conservative posture in the process.

Accounting Systems

Our accounting systems, which are in complete compliance with CAS standards, are described in detail in our disclosure statements and monitored to insure the maintenance of causal - beneficial relationships to the maximum extent practicable. We have undertaken recent initiatives placing particular emphasis on the effect of these systems on the costing of orders for spare parts. Through the filing of disclosure statements and the review of those statements by the Government, as well as through the review of forward pricing rate proposals and contract proposals, we maintain a continuing dialogue with the Government regarding the nature of our management accounting systems.

Team Approach

It has been our experience that the team approach is well understood and effectively implemented at the working level. It is unfortunate, however, that the team approach does not appear to be accepted at the higher levels of the customer community, a fact which is costly indeed.

One problem is that of uncoordinated studies, surveys, plant visits, symposia, audits and investigations requiring contractors to designate key managers to perform the communications interface function.

The military services, DCAA, GAO and the Inspector General, independent of each other have recently launched initiatives on a number of issues - spare parts pricing, data acquisition, quality surveys, compensation reviews, work measurement, should cost, procurement and property review, et al. These surveys run on the average from one week to a month.

Contractors are routinely expected to establish "mirror-image" teams to work with these various government task groups. The makeup of these industry teams are overhead type executives and the time consumed is significant.

We would recommend that the Office of Secretary of Defense, in conjunction with the Service Secretaries, establish a "corporate control" over these highly redundant and duplicative study activities. Contractors have no power or prerogative of their own to refuse to cooperate with these independently commissioned initiatives and each such action contributes to additional overhead expense.

Government Requirements

Raytheon, through CODSIA fully supports Acquisition Improvement Initiative No. 14 dealing with contract requirements, streamlining, and optimization. Unnecessary and ill-timed management systems, data reporting requirements, and imposed organizational prescriptions do, in fact, drive costs. In the past, industry objections to these practices have been too often rejected in negotiations on the grounds of being nonresponsive to Government needs. Greater use of draft RFP's and conscientious scrubbing of contract requirements offers a tremendous potential for savings.

Contract administration costs are also driven by the complexity of multiple reimplementing of the regulations. Theoretically the FAR is the single federal procurement regulation envisioned by the Office of Federal Procurement Policy as binding on all federal agencies.

In practice DoD, NASA, etc., have issued their own FAR supplements and each of the military services in turn has issued its own department supplement to the DoD FAR supplement.

This compounds the task of contract administration and thus creates pressure on staffing contractor contract administration offices. To the extent that contract administration is accounted for through overhead, then costs escalate accordingly.

Many local practices that have developed over the years deserve a "re-think" to evaluate their effectiveness. As an example, we believe the present method of conducting plant property surveys is inefficient and greatly in excess of what is needed. Generally, Plant Property Surveys consume too much time. The result is excessive costs to both the contractor and DoD without increasing benefit to either party. We believe that plant surveys should not be conducted any more frequently than 12 months from date of a previous survey. When a contractor plant maintains an approved property control system through two consecutive plant property surveys, the next survey should be delayed for at least 24 months subject, of course, to evidence of substantial apparent system faults as determined in accordance with FAR Subpart 45.5.

Finally the costs of accomplishing the disposal of property whether it be the disposal of excess/residual contractor inventory, facilities, special test equipment or special tooling generally exceed the value returned. Disposal procedures should be developed to recognize the costs expended by the contractor and DoD versus the benefit received. Certain categories of property (e.g., special tooling) which have a proven record of cost-ineffective screening results should be eliminated from screening requirements. Plant clearance personnel should strictly adhere to the 90 day screening requirements of Subpart 45.6, in order to minimize costs to the contractor and the DoD. Concurrent screening of DoD and other federal agencies should be conducted wherever feasible. In addition, the procedures established for conducting contractor sales of surplus Government property are too complicated, time consuming and costly.

Contractor Incentives

It has been our experience that contracting officers are reluctant to offer unusual incentives to contractors. The provisions for special profit in the regulations are rarely used.

At Raytheon we have well established employee motivation and suggestion plans which are managed and controlled at corporate level but require that each operating laboratory and plant administer plans at the local levels.

Some key statistics are presented to portray the viability and effectiveness of this plan:

Over 4,000 cost reduction/avoidance suggestions were submitted by government group employees in the first half of 1984 alone. Over 50% of these suggestions were determined, after management review, to be worthy of implementation. Cash awards of over $150,000 were made to sponsoring employees. The ratio of savings to awards was 12 to 1.

Economies are realized both in direct functions, i.e., fabrication, assembly, inspection, test, materials, etc., as well as in indirect (overhead) functions such as material handling, receiving inspection, administrative services, etc. Thus, both the direct cost base and the discrete overhead cost elements are constantly monitored for possible reductions.

A significant percentage of these savings will recur annually and redound to the Government through reductions in unit cost of manufacture of future buys of various Army, Navy and Air Force weapons systems.

People

The company has placed great emphasis on the attraction and careful selection of employees. We have established personnel programs that encourage employee growth and development, and provide for their fair treatment. This has enabled most of our senior management to be promoted from within. We have professional development systems for our engineering and administrative employees. These activities have resulted in growth opportunities that have led to a highly satisfactory employee retention rate.

1985 FEB -7 AM 9 19

OFFICE OF
THE SECRETARY OF DEFENSE

R. Anderson
Chairman of the Board and
Chief Executive Officer

Rockwell International Corporation

January 31, 1985

The Honorable William H. Taft, IV
Deputy Secretary of Defense
Department of Defense
Washington, D.C. 20301

Dear Secretary Taft:

We recognize the concerns expressed in your letter of December 31, 1984 and place a high priority on continuing efforts to achieve reductions in contract overhead costs. We have been taking, with full participation of all our key management people, a number of positive actions to control and reduce costs by either improving and refining established practices or taking new initiatives. Among these are careful and controlled manning of those programs for which we have responsibility and a formalized budgetary control system to maintain an effective balance of overhead support to contract work.

In the area of direct and indirect compensation for salaried employees, we have eliminated cost-of-living allowances and have initiated actions to contain fringe benefit costs. For example, we recently revised our health care insurance program to provide for employee cost-sharing which will result in significant cost reductions. Other fringe benefit areas are being continuously reviewed to determine whether similar cost reduction actions may be taken.

We are dedicated to continuing our efforts to reduce overhead costs. In doing so, we must remain mindful that our most valuable resource in discharging our Government program responsibilities is skilled and dedicated employees. To retain and, where appropriate, to attract qualified people, it is essential that our compensation and benefit programs continue to be reasonably competitive with the balance of industry and, accordingly our cost reduction actions have to be formulated in a manner which will permit us to maintain maximum effectiveness in discharging our program responsibilities.

Sincerely,

R Anderson

RA/vm

Corporate Offices
600 Grant Street, Pittsburgh, Pennsylvania 15219
2230 East Imperial Highway, El Segundo, California 90245

1985 JAN 29 PM 2:38
OFFICE OF
THE SECRETARY OF DEFENSE

SINGER

J B FLAVIN
CHAIRMAN
CHIEF EXECUTIVE OFFICER

January 21, 1985

The Honorable William H. Taft, IV
Deputy Secretary of Defense
The Pentagon
Washington, D.C. 20301

Dear Mr. Taft:

I have reviewed your letter of 31 December 1984 with respect to the reduction of contract overhead costs, and the ten principles of overhead cost control attached to the letter.

We, at Singer, wholly endorse your efforts to adopt meaningful overhead cost control incentives in Government contracts. To this end, Singer divisions doing business with the Department of Defense are constantly reviewing methods by which overhead costs can be reduced. Specifically, the cost factors and business volume which comprise overhead rates are examined for accuracy, cost effectiveness, and reasonableness. These efforts are overseen by senior Singer management at the corporate level. This constant evaluation process places responsibility for control on the divisions, and results in a system of accounting that measures performance at the incurred level and enables corporate to use overhead control as part of its division management performance criteria.

As indicated in your ten principles, the Department of Defense should also develop incentives for improved contractor performance in this area - the concrete inducements you mention appear to be comprehensive. Be assured that Singer supports your efforts to improve contract performance in this area, and will continue to follow-up on its efforts as well as the initiatives indicated in your ten principles.

Very truly yours,

JB Flavin

Joseph B. Flavin

1985 JAN 23 AM 11: 24
OFFICE OF
THE SECRETARY OF DEFENSE

SPERRY
SPERRY CORPORATION
1290 AVENUE OF THE AMERICAS
NEW YORK, NEW YORK 10104

G. G. PROBST
Chairman and
Chief Executive Officer

January 10, 1985

The Honorable William H. Taft, IV
Deputy Secretary of Defense
The Pentagon
Washington, D.C. 20301

Dear Mr. Secretary:

I was quite interested in the initiatives expressed in your 31 December letter on contract overhead costs, as I have just recently initiated a major reorganization within our defense and aerospace sector to achieve the same objectives.

Our reorganization will essentially eliminate two layers of management with a considerable savings in manpower, which will largely benefit our government customers. We expect to benefit through increased cost competitiveness in the marketplace.

I also expect additional benefits from our new organizational structure, which places increased activity in the hands of our functional business units. This is expected to improve our response time as well as increase our corporate visibility into the basic operating units.

It occurs to me that much of the defense industry overhead was created to respond to the increasingly detailed requirements of the customer. Your initiatives, and our reorganization, cannot achieve maximum success without a reversal in this trend.

If you are interested in further details of our reorganization, Ab Martin or I would be pleased to brief you at your convenience.

Sincerely,

G.G. Probst

1985 JAN 30 PM 4:50
OFFICE OF
THE SECRETARY OF DEFENSE

UNITED
TECHNOLOGIES

United Technologies Building
Hartford, Connecticut 06101
203/728-7000

Harry J. Gray
Chairman and Chief Executive Officer

January 25, 1985

The Honorable William H. Taft, IV
Deputy Secretary of Defense
Washington, D. C. 20301

Dear Mr. Secretary,

This is in reply to your letter regarding the Defense Department program for minimizing overhead costs. We at United Technologies have for some years been motivated by the goal of being the low cost producer of the highest quality products. Control of all costs, including overheads, has been and will continue to be central to our efforts.

Through the course of DoD evaluations of our efforts, we hope that you continue to recognize the leverage of dollars well spent today for benefits to be realized in the future. For example, our package of employee compensation must be competitive in order to attract and retain personnel who can meet our customers' needs both today and tomorrow. Moreover, we are making substantial investments in high technology capital equipment. In the short run these investments can create higher overhead expenses due to depreciation, planning and implementation. Nonetheless, we view these capital expenditures as an investment in the future which will yield significant reductions in long-term product costs. In this regard, we are taking advantage of the government's Industrial Modernization Incentive Program, but I would strongly recommend that other explicit incentive programs be established that could be folded into the area of rate negotiations.

Let me assure you that as a major defense supplier we are acutely aware of the need to be competitive and a key is the control of all elements of costs. I am enclosing a letter which Bob Daniell, our new President and COO, and I directed to all of our division presidents challenging them in specific business areas for 1985. As you can see, they mesh well with Department of Defense policies and objectives.

In summary, we agree with the overall emphasis on cost reduction and, specifically, in the overhead area. We believe that we have established aggressive internal control programs, but we welcome further dialogue with the Department of Defense, especially along the lines of establishing better incentive arrangements.

Sincerely,

Harry

Harry J. Gray

/th
attach.

Internal Correspondence

UNITED
TECHNOLOGIES

December 20, 1984

Messrs. R. S. Allen - Carrier Corp.
A. D. Autorino - Building Systems Co.
J. M. Bruce - Essex Group
L. L. DeSantis - Inmont
H. L. Ergott - Mostek
F. Jaulin - Otis
J. Lovkay - Hamilton Standard
R. G. Meyerand - Research Center
H. A. Michelson - Norden Systems
W. F. Paul - Sikorsky Aircraft
E. J. Rapetti - Automotive Group
A. E. Wegner - Pratt & Whitney

As a global company we have expanded and grown stronger by building technically superior products at competitive prices. We have an historic and proud record for management commitments to producibility which has continually improved the quality and lowered the cost of our products. Visionary management of products and people in every facet of our business is a prerequisite for future success.

As we start the New Year, we strongly encourage you and your managers to apply special emphasis in 1985 to:

- Identify "windows of opportunity" wherein capital investments in R&D, technology, processes and state-of-the-art equipment will render traceable quality improvements and cost reduction.
- Perform producibility planning that assures a complement of design and manufacturing wherein it is known worldwide that we design reliability and maintainability into our products. Be alert for value engineering opportunities to reduce cost and improve the "ilities".
- Establish measures of productivity which will enhance cost predictability. Material and process control cost factors must come more into focus. Yield, scrap, rework and work measurement standards must have true values in accounting for and efficient control of manufacturing burden. These absolute factors are also an integral part of the make or buy decision.
- Create people programs geared to obtaining their suggestions and to acknowledging their critical role in our producibility programs. A positive identity of UTC employees with the corporation and its products cannot be overstressed.

- Increase UTC interdivision activity to assure sharing of R&D, technology, and management "lessons learned". The UTC Research Center can serve as an excellent catalyst for bringing corporate technology opportunities to fruition.
- Explore defense acquisition policies which offer contract cost sharing and other incentives to encourage cost reduction and improved quality through enhanced technology and plant modernization. These policies are a complement to UTC's goals.

Inherent in our pursuit of leadership in the world marketplace is your more active role in the areas which we have highlighted. Success will materialize only through the creativity and leadership of UTC management. We have faith in your ability and will watch your progress in the coming year.

Harry
Harry J. Gray

Bob
Robert F. Daniell

1985 FEB -8 PM 3:
OFFICE OF
THE SECRETARY OF DEFENSE

**Westinghouse
Electric Corporation**

**Energy and
Advanced Technology
Group**

Thomas J. Murrin
President

Westinghouse Building
Gateway Center
Pittsburgh Pennsylvania 15222
(412) 642 3110

January 30, 1985

The Honorable William H. Taft, IV
Deputy Secretary of Defense
Department of Defense
The Pentagon
Washington, D.C. 20301

Dear Secretary Taft:

Our Chairman Mr. Doug Danforth asked me to respond to your thoughtful letter concerning reductions in overhead costs.

I should note that Doug Danforth has been driving our entire Corporation for the past four years toward his goal of high quality products and services accompanied by a lowering of costs; both direct and indirect. We at Westinghouse are making Productivity and Quality Improvement a way of life --- and this entails close attention to, and control of, overhead costs.

The competitive industrial capabilities developing abroad --- particularly in Japan and the Pacific Basin --- have fostered a keen sense of urgency on our part. As a result, Westinghouse is engaged in a two billion-dollar, five-year Facilities Modernization Program. Our Defense Group is a major participant in the overall improvement of the Corporation's Productivity and Facilities investment --- and several hundred million dollars have been slated for the activities of our Defense Group. Directly associated with the "lessons learned" from visits made to foreign countries' industries, we have implemented such programs as Quality Circles, and Productivity Centers; a multi-million dollar Productivity Seed Fund; "Office of the Future" programs; Advanced Robotics and other cost-effective Automation.

In accordance with my objective of delivering high performance, quality weapon systems in a timely manner at reasonable prices, I have continually emphasized to all of my line managers the real need to tighten our controls on all costs --- both direct and indirect --- including the conceptual and early design phases. In addition, I require vigorous justification and high level approval of all overhead personnel hiring. We have instituted a Salary Incentive Plan for all our Defense professionals --- that is, the Individual Salary Incentive Program (ISIP) --- tying all future professional salary increases to individual performance against objectives. Thus, no longer do our professionals receive general cost-of-living (GENCOL) increases automatically each year. We believe that the benefits here will be significant.

Fringe benefits --- especially employe medical costs and insurance premiums --- are now under greater pressure for reduction. For example, required second medical opinions --- and a larger share of costs to be borne by employes --- will assist in controlling a cost which is of concern to all. In the area of travel, we now have one carefully selected travel agency for our entire Defense Group --- rather than forty plus agencies. This procedure has provided us with lower costs --- and greater control and visibility of our employes' travel costs and activities.

It should be noted that while Westinghouse and other companies throughout the Nation are striving to reduce total costs, an interesting phenomenon is occurring. To lower costs --- both direct and overhead --- Industry is moving towards automation; causing some increases in automation related overhead costs. Therefore, it must be recognized that not all increases in overhead costs are necessarily wasteful. As a matter of fact, technological increases in overhead costs for effective technological thrust are desirable. We fully expect this trend to continue in the long-term.

We at Westinghouse are involved in a two-pronged attack on overhead costs. Technological increases in overhead which clearly will improve our total cost picture are encouraged, while traditional overhead costs --- such as employes involved in paperwork which might not be absolutely necessary --- are subject to very close scrutiny for possible reduction, or elimination.

Several investments made to date which are providing cost savings for the Government and Westinghouse are as follows:

The Westinghouse Manufacturing Systems and Technology Center (MS&TC), is a "Center of Excellence" which consolidates and focuses those key strategic manufacturing support functions required to implement the overall Westinghouse productivity strategy. MS&TC --- which occupies 46,000 square feet --- is the focal point for developing and implementing the Defense Business Unit's advanced production processes, techniques, and equipment. Primarily, it links the engineers who design electronic systems --- such as radars --- with the manufacturing process engineers and the operators who build these products.

Westinghouse developed another unique "Center of Excellence" that enables it to compress the amount of time between when material is ordered to when it is installed in a system. Compressing this cycle time helps reduce space and inventory --- and assures a more efficient manufacturing flow. This 112,000-square-foot facility is called the Material Acquisition Center (MAC). MAC represents a complete redesign --- and radical improvement --- of the material acquisition and inventory control processes.

Our material acquisition cycle time has already been reduced from 23 weeks to 12 weeks --- with a planned goal of 4 weeks by 1987. On-time material availability has been improved from 47 percent to 85 percent --- with a planned goal of 90 percent by 1987. Additionally, we have increased the number of transactions processed per employe in the procurement cycle by 19% --- and the dollar value of purchase orders written per person (after adjustment for inflation) has increased by 84%.

In early 1983, Westinghouse opened the doors of another "Center of Excellence" --- our revolutionary new 180,000-square-foot factory --- the Westinghouse Electronic Assembly Plant, in College Station, Texas. The implementation strategy for this "Center of Excellence" called for two distinct phases --- involving the application of the creative intelligence of a highly trained and motivated workforce with the incorporation of automated computer-integrated, robot-based manufacturing systems. These systems are ideal for the broad mix, small lot size, high change rate, and demanding quality requirements of the Defense Electronics Industry. The goal of our Electronic Assembly Plant is to manufacture electronic assemblies at the lowest possible total cost so as to provide the on-time delivery of quality products to our customers. This very successful project was part of a comprehensive Tech Mod Program with the Air Force --- and is described in the attached brochure.

Overall, we are deeply involved in the commitment to reduce the cost of weapon systems. AFSCMD has recognized our efforts by awarding our Baltimore Defense site with several Productivity Awards. A number of Cost Monitoring Reviews were conducted with significant benefits for both the Government and Westinghouse. It is our firm intention to continue to work diligently with Government representatives to obtain meaningful cost reductions --- while at the same time improving product quality.

We applaud and heartily support your initiatives to reduce overhead costs and to streamline over-specified and non-cost effective contract requirements. I am of the opinion, however, that your initiatives should be extended to a critical review and analysis of all administrative requirements for reports and data requests placed on defense contractors --- which may be over and above contractual requirements. I recommend a joint effort by the Government and Industry to examine all of these Government requirements and requests for possible streamlining or elimination; using the spirit of the Paperwork Reduction Act as a guide. This is a fruitful area for meaningful overhead cost reductions for Industry as well as the Government.

My purpose in outlining some of our accomplishments is to emphasize that we at Westinghouse --- from our Chairman, Doug Danforth to the factory maintenance employe in our Quality Circles --- are dedicated to producing quality products at lower costs. Such action is necessary to order to establish a climate where innovation and productivity can flourish and allow us to "Rearm America" at the lowest possible cost --- while maintaining our U.S. Aerospace and Defense preeminence in the global marketplace.

Most sincerely,

Tom

T. J. Murrin

Enclosure

cc: D. D. Danforth - Chairman
Westinghouse Electric Corporation

1985 JAN 23 AM 10: 34
OFFICE OF
THE SECRETARY OF DEFENSE

Aerospace Industries Association of America, Inc.

Office of the President

January 14, 1985

The Honorable William H. Taft, IV
Deputy Secretary of Defense
The Pentagon Room 3E944
Washington, D. C. 20301

Dear Secretary Taft:

Thank you for sending us the "Principles on Overhead Cost Control", transmitted with your letter of December 31, 1984.

It goes without saying that we share with you the objective of doing everything possible to improve the defense procurement system, including ensuring appropriate control of overhead costs. To that end, I have transmitted the principles to AIA member companies with a request for prompt comments. I know that such comments will be made constructively and will be given serious consideration.

Again, many thanks.

Yours very truly,

Karl G Harr

Karl G. Harr, Jr.

1725 DeSales Street, N.W. Washington, D.C. 20036 • (202)429-4600

1985 MAR 18 PM 3:49

OFFICE OF
THE SECRETARY OF DEFENSE

Aerospace Industries Association of America, Inc.

Office of the President

March 14, 1985

The Honorable William H. Taft, IV
Deputy Secretary of Defense
The Pentagon
Washington, D. C. 20301

Dear Secretary Taft:

The Aerospace Industries Association appreciates the opportunity to provide comments on the initiative to achieve reductions in contractor overhead, as set forth in your December 31, 1984 letter. We endorse the idea that the Government and its contractors must work jointly toward the achievement of common goals, such as overhead cost control.

In this connection, your letter mentioned that DoD would be looking for improvements in the use of existing tools and the creation of new ones to improve oversight and control of overhead costs. In seeking to improve existing tools, we think it important that your principles be applied within the framework of other established rules or principles. For example, application of the principle concerning allocation of costs should observe the binding requirements of the Cost Accounting Standards. Similarly, statutory obligations to follow disclosed cost accounting practices must be respected. In applying the principle on personnel costs, we think it important that compensation be viewed, not simply as a cost of performing contracts, but also as a management tool by which long term gains in productivity and quality can be achieved. Evaluations of compensation costs should be made on the basis of the reasonableness of total compensation rather than on an element-by-element basis.

With respect to the principle on the business base, its implementation must recognize that future business volume projections are necessarily judgmental and subject to the anomalies of the competitive marketplace and the attitudes of the Congress. While such projections may be relied on in developing allocation bases, they are not factual data as contemplated by P.L. 87-653 and should not be considered as such.

Finally, many of our members have expressed concerns about the possibility of overzealous application of your principles. While agreeing that gains in cost effectiveness may be available via judicious application of the principles, our members believe that U.S. Government oversight of industry overhead is, at best, a weak substitute for the pressures of the competitive marketplace. We think it important that application of overhead cost control initiatives be selective so that the

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U.S. Government obtains a reasonable return on its investment -- while avoiding further increases in its own overhead. We believe that, outside of validating allocation practices, there is little or no oversight role for the U.S. Government to play with respect to a business segment primarily involved in commercial work. Similarly, the presence of large, long term, firm fixed price contracts will stimulate prudent management of overhead far more effectively than will any U.S. Government oversight program. We raise this point because, in years past, we have often seen well-intentioned U.S. Government programs turn out to be counterproductive to taxpayer interest because of universal application of management techniques or initiatives which make sense only in a given set of circumstances. While our point regarding selective implementation may be implicit in your initiative, you may wish to make it explicit, to increase chances that U.S. Government management resources are used effectively.

We hope that these brief comments will be of assistance in your efforts to implement a meaningful effort to contain overhead costs. Should you desire a more detailed discussion of this matter, we would be pleased to arrange a meeting with representatives of our member companies to discuss existing overhead controls that are commonplace in our industry.

Very truly yours,

S. L. Knight
for Karl G. Harr, Jr.

American Electronics Association
Government Operations Office

AEA

1612 K Street N.W.
Washington, D.C. 20006

(202) 331-8050

March 20, 1985

The Honorable William H. Taft, IV
Deputy Secretary of Defense
The Pentagon
Washington, D.C. 20301-6030

Dear Mr. Secretary:

The American Electronics Association welcomes this opportunity to comment on your initiatives to reduce contractor overhead costs. This association wholeheartedly supports your overall objective, and our comments are offered in a spirit of cooperation toward meeting these goals.

AEA represents over 2,800 member companies which encompass all segments of the electronics industries, including manufacturers and suppliers of computers and peripherals, semiconductors and other components, telecommunications equipment, defense systems and products, instruments, software, research and office systems. The AEA membership includes companies of all sizes, from "start-ups" to the largest companies in the industry. Only a fraction of AEA's members perform contracts or subcontracts for the Federal government. The greatest number of the AEA membership (71%) are small companies employing fewer than 250 employees. AEA member companies account for 63 percent of worldwide sales of the U.S.-based electronics industries.

Currently employing 2.5 million Americans, the electronics industries are among the fastest growing in the economy. Already, the electronics sector constitutes the largest single manufacturing industry in the United States. Its payroll of over $50 billion provides more than $7.5 billion of federal payroll revenues.

Our members, your suppliers, are well aware of the close scrutiny of Department of Defense spending by Congress. We too have received the message to reduce inefficiencies in defense spending. However, we do not regard this as a mandate to turn defense contractors into government companies managed by the Department of Defense. The free enterprise system has always been the bulwark of our defense industry. Free enterprise offers not only innovation and motivation but quality and cost control. It is our position that DOD should use the strengths of this system to accomplish the objectives toward which we all strive. To this end, we believe your principles of overhead cost control fall short of the mark in several areas.

The Competition in Contracting Act of 1984 provides a legislative basis for effective overhead cost control. The tenets of this law take advantage of the strengths of free enterprise to attain the ultimate result you wish to accomplish. AEA strongly encourages maximum use of competition in procurement to reduce overhead costs by challenging defense contractors to reduce costs as well as by sidestepping the many inefficiencies associated with negotiated procurements.

Several of our comments directly address the "Principles of Overhead Cost Control" attached to your letter. First, the "Team Approach" principle should include the contractor. It is the contractor's management that is best able to affect overhead costs within its own organization. With this in mind, the individual contractor should always be the principal determinant of both overhead structure and indirect expenditures within its own organization. Anything less would undermine essential management prerogatives within our free enterprise system. DOD should test overhead costs as to overall reasonableness or regulatory allowability. While costs should be reviewed and audited to the lowest level, elemental level costs should be managed by the contractor and not subjected to "second guessing" by outside organizations.

With regard to DOD audit and review practices, AEA recently testified before the Senate Armed Services Committee suggesting ways to improve and coordinate these activities. I am sending a copy of that testimony for your review.

The "Prospective Pricing" principle deserves the priority emphasis you suggest. DOD must take the actions necessary to reasonably satisfy itself that it is paying a fair price for any product acquired. No contracting officer should sign a contract without first being satisfied that the Government has paid a fair and reasonable price. However, once the price is established, the contractor should have the incentive to increase profits through (overhead) cost reductions without the concern that a post award audit will result in a contract price reduction. DOD benefits from this because contractor efficiencies are realized in other contracts and a reduced actual cost history is often the basis for future cost estimates on follow-on procurements. Increased use of contracting incentives, as addressed in the "Contractor Incentives" principle, is supportive of this concept and should be encouraged whenever appropriate.

Finally, with respect to the "Business Base" principle, it is unreasonable to ask a government contractor to certify, as cost and pricing data, the projected business volume underlying forward pricing rate agreements. It would be no less unreasonable to ask the Government to certify that it will in fact provide that business base to the contractor.

In summary, the American Electronics Association supports your efforts to reduce overhead costs. However, we respectfully suggest that the best approach is to make use of the management advantages inherent in the free enterprise system in part by maximum use of the concepts set forth in the Competition in Contracting Act of 1984. DOD micromanagement of its contractors' overhead costs will only perpetuate current problems and add to contract costs, while discouraging commercial enterprises from engaging in government contracting activities.

Again, while our comments may, at times, represent a different perspective on the matter of overhead cost control, they are offered with a cooperative spirit. Members of AEA's Government Procurement Committee would be pleased to meet with you or your representatives to discuss this matter further.

Sincerely,

Kenneth C.O. Hagerty
Vice President, Government Operations

Enclosure

1985 JAN 17 PM 4:01
OFFICE OF
THE SECRETARY OF DEFENSE

NATIONAL SECURITY INDUSTRIAL ASSOCIATION
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Vice Chairman,
Executive Committee

W.H. Robinson, Jr.
President

JAN 11 1985

The Honorable William H. Taft, IV
Deputy Secretary of Defense
Room 3E944
The Pentagon
Washington, D.C. 20301

Dear Mr. Secretary:

This is in response to your letter of 31 December 1984 outlining the established ten principles of overhead cost control, and requesting our ideas on how industry can reduce overhead costs. We appreciate this opportunity to participate in this program aimed at providing significant and tangible contract overhead cost reductions.

The National Security Industrial Association will join in a Council of Defense and Space Industry Associations (CODSIA) project to respond to your request for recommendations on this subject.

Sincerely,

Wallace H. R

Wallace H. Robinson, Jr.
President

THE SECRETARY OF DEFENSE

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W.H. Robinson, Jr.
President

MAY 6 - 1985

The Honorable William H. Taft, IV
Deputy Secretary of Defense
The Pentagon Room 3E944
Washington, D.C. 20301

Dear Mr. Secretary:

As a follow on to our letter of 11 January 1985, the National Security Industrial Association herewith submits comments dealing with your 31 December 1984 letter pertaining to initiatives aimed at reducing overhead costs.

We share your concerns for overhead control. It should be recognized, however, that many companies in the industry already maintain cost reduction/containment programs in all areas of cost, not just overhead. These programs recognize the need to remain competitive, be responsive to management and shareholders, and provide goods and services to all customers, including DOD, at fair and reasonable prices.

Of course, the Government, too, has recognized the need to stimulate cost reduction in all areas. Examples of these initiatives include the Industrial Modernization Incentive Program, the Competition Advocacy Program, Secretary Weinberger's spare parts acquisition reform program, as well as your ongoing initiative which focuses on overhead. NSIA supports all of these initiatives and believes that through a comprehensive and coordinated program which is responsive to, and recognizes the interrelationships among all of these efforts, significant cost reducitons can be attained on an across-the-board basis.

In addition to commenting on the specific initiatives set forth in your letter, we would also like to provide some general thoughts that we believe should be considered with respect to issuance of any formal implementing guidance on overhead issues. Consideration of these points, along with our comments enclosed in Enclosures "A" and "B," will, we believe, support our view that reductions in contractor overhead costs can best be achieved through a cooperative effort. Of course, these points have been stated before:

- Some cost growth experienced in the overhead area has resulted from transfer of direct costs to indirect costs as a result of the application of advanced technologies and automation.

- An overhead rate expressed as a percentage cannot, by and of itself, be categorized as high or low. An overhead percentage is merely a mathematical calculation of indirect dollars divided by an allocation base, and both of these elements can vary widely depending on the circumstances.

- The total cost of the product should be the criteria, not the percentage of overhead. Overhead should be analyzed in conjunction with total product cost.

- Industry detractors often accuse defense contractors of lacking the incentive to reduce overhead costs on the premise that such costs are readily passed onto the Government in the form of indirect costs. What is not recognized is that defense contractors have always placed significant emphasis on overhead containment in order to maximize their competitive posture. Since indirect costs must also be allocated to commercial business, contractors have a compelling and continuing need to reduce indirect costs across their entire business base. Assistant Secretary of Defense (Comptroller) Robert W. Helm, in a March 19, 1985, letter to Senator Carl M. Levin of the Senate Armed Services Committee, Subcommittee on Defense Acquisition Policy, confirmed these points.

- It has long been demonstrated that industry being consulted before implementation of any initiatives is most constructive. Uncoordinated initiatives often resolve only the perception of the problem and not the problem itself.

- Many overhead costs are a result of government imposed policy, legislation, regulation, guidance, surveillance and oversight. Recent expansions in industry regulation, along with the increase in surveillance and oversight, have adversely affected contractor costs and resulted in increased overhead. This point should be addressed in any cost containment type of study.

NSIA believes that your program, prudently and judiciously implemented, will afford adequate incentive for overhead reduction/containment, and no specific contract incentives are required to insure industry support.

Defense contractors are vitally interested in a meaningful program to reduce the cost of doing business with the Government for a variety of reasons, not the least of which is to correct the unfortunate public perception of the DOD and the defense industry. A cooperative effort by the DOD and its contractors will be beneficial in attaining this mutual goal.

We shall be pleased to meet with you to amplify our recommendations and work toward our mutual objective of structuring and implementing a meaningful program. The NSIA point of contact is Col. E. H. Schiff, who may be reached at 202-393-3620.

Sincerely,

Wallace H. Robinson, Jr.
President

Enclosures

Enclosure A

Additional areas for your consideration in developing a comprehensive cost reduction program include:

1. Spare Parts Acquisition

There have been instances of embarrassment to both the DOD and industry in the acquisition of spare parts. These have been blown into horror cases which have caused significant reactions from the Congress, the IG and the GAO. As a result, individual elements of the acquisition community have unilaterally initiated corrective directives - each somewhat unique - to prevent or correct perceived problems. This in turn results in the need for multiple reactions on the part of industry, i.e., one reaction to each Service and/or contract administration agency. The cost of these reactions can well exceed the savings anticipated from the newly imposed controls. Acquisition of spare parts is not a problem posing unique requirements upon each of the Services. It is time to establish a unified DOD wide policy that will provide a logical and effective solution to this generic problem area. Such a unified policy and approach, supported by the cooperative participation of industry, can prevent further embarrassment and reduce both overhead costs and spares prices.

2. Contractor Weighted Average Share in Cost Risk Program (CWAS)

The CWAS program, which was established in 1966, was developed by the Department of Defense and was applicable to contractors who had at least a seventy-five percent (75%) mix of commercial and fixed-price-competitive contracts. For those contractors who were CWAS qualified, DOD considered that "the free marketplace" effectively controlled indirect costs. The CWAS concept resulted in lower administrative costs for both the government and industry, but this progressive program has now been eliminated with a resulting increase in DOD and contractor effort devoted to the review of normal costs of doing business. We recommend that this concept be reconsidered with any necessary changes being made to correct any perceived shortcomings rather than rejecting a basically beneficial program.

3. Access to Records

During recent years, DCAA has increased its demand for contractor management data (e.g. profit plans, management studies, accounts unrelated to expenditures on government contracts, etc.) which require added support and effort. Defense contractors recognize the right of DCAA to review, evaluate and judge contract costs. The "need to see every paper in the plant" approach to records review is an over-reaction and can only work to the detriment of your fundamental objective to forge a cooperative program to reduce/contain overhead costs.

4. Duplicative Reviews and Audits

Contractors are subject to numerous duplicative reviews and audits which involve areas such as pensions, insurance, compensation programs, etc. These reviews are usually performed by DLA and/or Service specialists. However, in too many instances DCAA and other government and DOD agencies will also separately review these areas. This duplication of effort and its resultant cost to both parties is unnecessary and wasteful.

5. DCAA Operations Audits

DCAA continually imposes upon contractors operations audits which, in too many cases, are not meaningful to the contractor. The resolution of these "audits" involves significant activity and cost for both the contractor and Government. We recognize that not all operations audits are unproductive, and propose that auditors audit costs but that other specialists do voluntary operations analysis-type reviews. In essence, DOD would be offering a consulting service to those Government Contractors who might welcome such reviews. No "mandatory" audit reports should be issued. There is a great need to share information to techniques and we now do it to some extent but are somewhat inhibited by anti-trust, competition and ethical considerations. Most contractors would be pleased to share with these DOD specialists their success in addition to receiving information that would help contain costs. We think the most important DOD objective should be to provide the leadership for and encourage cost containment programs in a non-adversial atmosphere.

Enclosure B
Principles of Overhead Cost Reduction

To aid in your implementation of this initiative, we are providing comments relative to selected items of the proposed program.

- Prospective Pricing

  To achieve agreement on sound forward pricing rates, government representatives must be prepared to recognize and understand a contractor's business projections and the requirements such activity places on support functions (i.e. overhead). Government mandate of an overhead rate to be used for billing and bidding based on a unilateral determination of possible cost avoidance should not be perceived as a method to reduce costs.

- Continuous Evaluation

  It must be recognized that forward pricing projections are the best estimates at the time prepared, and updates of these projections based on current data may result in higher or lower rates. Forward Pricing Rate Agreements usually allow either party to update a previous estimate. Understanding of the systems used to support projections would result in few and minor instances of disagreement when necessary revisions are made.

- Business Base

  We believe certification of projected business volume is inappropriate; only the underlying data that is of a factual nature should be certified for cost and pricing data purposes, consistent with the existing implementing regulations of Public Law 87-653.

- Discrete Cost Analysis

  Results of the evaluation tools and programs listed should not be mandated without contractor participation. Factors outside "hard core" data may invalidate results unless contractor input is considered. If only Government is involved in review and contractor input is not considered, conclusions may be erroneous and recommendations may be inappropriate.

- Personnel Costs

  Our comments relative to Duplicative Reviews and Audits (Attachment "A" - Item 4) are especially pertinent to this principle. A designated Government specialist, working under a single unified program, should be the person to evaluate these areas because of the expertise required to make a knowledgeable judgement.

- Accounting Systems

  This area is one in which a cooperative effort between the contractor and DOD could lead to understanding and acceptance of the contractor's total accounting system. Once this is accomplished, any deviations from the system can readily be identified.

- Team Approach

  We emphatically endorse your commitment to a team approach by government management. Such an approach, fully implemented, can significantly reduce redundant and wasteful oversight, and result in more effective communication between government and industry.

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OFFICE OF
THE SECRETARY OF DEFENSE

MOTOR VEHICLE MANUFACTURERS ASSOCIATION
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1620 EYE STREET, N.W., SUITE 1000 • WASHINGTON, D.C. 20006 • AREA 202-862-3900

W. PAUL TIPPETT, *Chairman*
V. J. ADDUCI, *President and Chief Executive Officer*
THOMAS H. HANNA, *Senior Vice President*

January 10, 1985

The Honorable William H. Taft, IV
Deputy Secretary of Defense
The Pentagon
Washington, D.C. 20301

Dear Mr. Taft:

I have received your recent letter regarding your initiatives to reduce contract overhead costs and passed them on to our member companies for their consideration.

Thank you for apprising me of this program.

Very truly yours,

V. J. Adduci

TLX NO. 705211 AUTOMAKERS WSH. UD

Mr. **McCloskey**. The chairman has suggested perhaps your group does not have enough auditors. How do you feel as far as staffing allocations now, and could that be improved?

Mr. **Taft**. We have asked for an increase in auditors in the 1986 bill, not only for the DCAA but also for the inspector general. And I would hope the committee would support that request. The numbers will be provided for the record.

[The following information was received for the record.]

DCAA has requested a total of 222 auditors for FY 1986. The total FY 1986 audit staffing increase for the Office of the Inspector General is 27. These additions will bring the number of auditors in DCAA to 4,115 and in the DoD IG to 510 by the end of FY 1986.

We have had over the years good support from this committee. We have increased the number of auditors each year in the amounts we have requested. And we are asking it again. And I anticipate good support for it.

Mr. **McCloskey**. I believe Senator Sasser has suggested that these functions could be more appropriately handled by the inspector general's office alone.

Could you comment on that, and also comment on your working relationship with the inspector general's office?

Mr. **Taft**. My working relationship with the IG's office is very good. I think the inspector general would tell you the same thing. We have never—although it is in the legislation—I will say that we have never restrained him from any investigation that he wanted to make. We have, quite the contrary, encouraged him to go out and dig into anything and everything that he can. Sometimes we wish that he didn't find things that are out there; they don't help us in our public image. But if they are there, I would rather he find them. We work with them and Mr. Starrett.

Mr. **Starrett**. It has worked very well. But the mission of the IG is different from the mission of the Defense Contract Audit Agency. I think one of the best ways to point that out is to say that in this bill there is a requirement for the DCAA auditor to attend negotiations. That is an operational type function.

We are assisting procurement in negotiating prices, and if we were in the IG then we would have to wear two hats, and that would make it very difficult and I doubt if we would be invited to negotiations, which is an operational type function.

Mr. **McCloskey**. Thank you.

Mr. **Nichols**. Mr. Hopkins.

Mr. **Hopkins**. Thank you, Mr. Chairman.

Mr. Taft, let me ask you, have any corporate contributions to political officeholders or candidates for that particular office ever been charged to the Government directly or indirectly, to your knowledge?

Mr. **Taft**. I am aware of at least one instance in which political contributions were charged—were claimed, I should say—and that involved the Boeing Co. I believe it received some publicity some months ago. They were disallowed by us.

But yes, that is one instance I am aware of.

Mr. **Hopkins**. Who was the recipient of that?

Mr. **Taft**. I am not familiar—I believe there were State and local candidates, is my impression.

Mr. **Hopkins**. Mr. Taft, let me say to you that I am not upset with you, but I am frustrated. I think that speaks rather broadly for the public who want to support a defense and do the right thing. Somehow they feel like they are being mistreated by their own government; perhaps not treated fairly, if you will.

I just looked at the list submitted last week by Mr. Cofer before the subcommittee where Sperry claimed $177,000, Rockwell claimed $144,000—Rockwell also claimed $314,000—Boeing claimed $11,000, and on and on and on down the list.

I asked Mr. Cofer last week, when he had selected seven companies at random, if all of them were guilty of some wrongdoing. He said yes, that they were; that they had all submitted unallowable things. I expanded that and asked, what if we had 20 companies? He said, they would all be guilty.

My question is: What do you suppose would happen to the little taxpayer if the IRS were on him for $144,000, $177,000, $314,000, or $1,000? I think we have evidence where many of those people have gone to jail. I am sure you would agree with that.

I see your testimony here says that the imposition of penalties is thus handled through legislation. Will this legislation help you? Will it give you more thrust to put these people in jail, if necessary?

Mr. **Taft**. As I understand the legislation, it would not give us any criminal sanction such as putting people in jail. It is a civil sanction that is anticipated by it.

Mr. **Hopkins**. Do you think that criminal sanctions are necessary, Mr. Taft?

Mr. **Taft**. I think in the case of where there is fraud and criminal intent exists, that certainly the criminal sanction is there. I believe that it does exist in the United States, in title 18, that there are sanctions for these types of activities.

Let me say in response to your earlier point, though, that there are two things going on here and they are rather different. One is the submission of costs that are quite clearly unallowable, those that we are familiar with, and when they are called to the attention of the companies usually they say, "That is ridiculous. We certainly shouldn't have submitted that." And everybody else says the same thing, and it is out. We have got to get rid of that practice of these things being submitted.

There are also legitimate areas of difference between companies and the department as to accounting practices and things of that sort that we need to have a forum to resolve. This is similar to the treatment of the IRS. I guess I would be surprised if the seven companies you named, or 20 others, didn't each of them have a dispute going on right now with the IRS over what they owe in taxes for many backyears. I would be absolutely stunned.

I never, when I was in private practice, represented a client who didn't have an argument with the IRS about one thing or another. There is nothing wrong with having an argument, and we need to have efficient, fair ways of resolving those arguments. And I think that may be what is going into a number of those questioned costs. There is also the first type, which we have got to get rid of.

Mr. **Hopkins**. Mr. Chairman, may I have unanimous consent to continue for a couple of minutes?

Mr. NICHOLS. Certainly.

Mr. HOPKINS. I called the staff last week and told them that I think people are tired of wanting to have a strong defense. These people are getting away with things that they as individuals can't. I called the staff and said, "Why don't we have criminal proceedings put on these companies?" I was informed this morning—as you mentioned in the United States Code, title 18, Section 287, which says whoever makes or presents to any person or officer in the naval military or naval service of the United States or to any department or agency thereof, any crime upon or against the United States, any department or agency thereof, knowing such claim to be false, fictitious or fraudulent shall be fined not more than $10,000 or imprisoned not more than 5 years, or both. This goes back to before it was revised in 1948.

Have you sued anybody, Mr. Taft? Have you sent anybody to prison for these fraudulent claims?

Mr. TAFT. The Defense Department has referred fraud cases to the Department of Justice in the time that I have been there, in increasing numbers.

Mr. HOPKINS. Which ones?

Mr. TAFT. I will provide them for the record. I am familiar with one or two from my days as general counsel, and we have obtained convictions—I don't think as many as we would like. But the Department of Justice makes those prosecutorial decisions.

Mr. HOPKINS. Let me interrupt you, if I may. I appreciate your sending that in to the committee.

Mr. TAFT. I will do that.

[The following information was received for the record:]

DEPARTMENT OF DEFENSE CONVICTIONS FOR FRAUD RELATED ACTIVITY, JANUARY 1983 TO MAY 1985*

The attached lists include Federal District Court convictions for fraud and corruption related cases of the following types:

Bribery of Government Officials
Conflict of Interest
Antitrust
Procurement
Property Disposal
Commissary Subsistence
Nonappropriated Funds

The lists do not include convictions for pay and allowance fraud, fraudulent personnel actions, or general theft of Government property other than embezzlement and other fraudulent schemes in the procurement process.

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* Resulting from cases referred to the Department of Justice for prosecution.

Prepared by the Office of Inspector General, Department of Defense, July 5, 1985

U.S. ARMY CRIMINAL INVESTIGATION COMMAND (CIDC)

TITLE	CATEGORY OF INVESTIGATION
Nilson Van & Storage	Rate/Price Fixing and Bid Rigging
Nilson, Howard A.	Rate/Price Fixing and Bid Rigging
Columbia Moving & Storage Co.	Rate/Price Fixing and Bid Rigging
Boineu's, Incorporated	Rate/Price Fixing and Bid Rigging
Boineu, Charles E.	Rate/Price Fixing and Bid Rigging
Hall, Shirley F.	Procurement Fraud
Watson, Robert L.	Contract Fraud
A.J. Fowler Corporation	Contract Fraud: False Performance Certification
Fowler, Jerry M.	Contract Fraud: False Performance Certification
Fowler, Andrew M.	Contract Fraud: False Performance Certification
Allied Management Corporation	Contract Fraud and Bribery
Jets Venture Capital	Contract Fraud and Bribery
Barnette, Larry D.	Contract Fraud and Bribery
Barnett, Leo J.	Contract Fraud and Bribery
Gibbs, Thomas E.	Contract Fraud and Bribery
Sentner, Murray	Bribery and Conflict of Interest
White Stone Restorations, Incorporated	Contract Fraud and Bribery of Government Official
Kaptain, John	Bribery, Contract Irregularities
Tolber, George W.	Contract Fraud, Bribery and Bid Irregularities
Watson, Robert L	Contract Fraud and Conflict of Interest
Insouth/Microwsystem:	
Rue, Victor W.	Contract Fraud: Bribery and Bid Irregularities
Koter, Richard A.	Contract Fraud: Bribery and Bid Irregularities
Asante, Abraham V.	Fraud: Forged Professional Documentation

AIR FORCE OFFICE OF SPECIAL INVESTIGATIONS

TITLE	CATAGORY OF INVESTIGATIONS
Automation Service, Incorporated	Procurement: Cost/Labor Mischarging
L.E. Werth & Sons	Bribery of Government Inspector
Fiesta Corporation/ Outlaw, James R.	Procurement Fraud: Progress Payments
Jenkins, Eddie	Nonappropriated Funds Fraud: Inventory
Cherokee Contractors Allen, Larry	Procurement Fraud
Quality Fabricators of Georgia, Incorporated	Procurement Matters: Substitution/ Nonconforming Product
Griggs, Pamela	Nonappropriated Fund Matters
George, Donna	Nonappropriated Fund Matters
Juares, Raymond	Bribery of Government Inspectors
Davila, Lonis	Bribery of Government Official
Zombakis, Demos	Bribery of Contracting Offical
Odom, David	Nonappropriated Fund Matters
Jensen, Lewis	Property Disposal Matters
West, Francis	Commissary/Subsistance Matters: Mispricing
Hanes, Donald	Procurement Matters
Brown, James	Property Disposal Matters
Fournier, Suzanne	Nonappropriated Funds Matters
Campbell, Ethel	Nonappropriated Funds Matters: Diversion of Goods
Tuitelle, Joyce	Nonappropriated Funds Matters: Diversion of Goods
Mantikas Painting Contractors	Procurement Fraud: Cost/Labor Mischarging
Baldy, Gayle	Nonappropriated Fund Matters
Reynolds, Bryan	Procurement Fraud
Holley Electric Corporation	Procurement Fraud
One Stop Motor Parts, Inc.	Procurement Fraud
Anderson, Greg	Procurement Fraud
Whitson, Susan	Nonappropriated Fund Matters
Tucker, Gwendolyn	Nonappropriated Fund Matters
Bishop, Charlotte	Nonappropriated Fund Matters
McDonnell, Cyril	Nonappropriated Fund Matters
Malendes, Alvaro (multiple cases)	Forgery and Counterfeiting
Mayton, George	Bribery
Collins, Richard	Bribery
Mosley, Michael	Larceny by fraud
Raymond, Monnie	Nonappropriated Fund Matters
Woolard, Moye	Nonappropriated Fund Matters
Chan, James	Nonappropriated Fund Matters
Parker, Johnie	Nonappropriated Fund Matters
DeLaisle, Lillie	Nonappropriated Fund Matters
Bumsted, Kimberly	Nonappropriated Fund Matters
Bonham, Sherry	Nonappropriated Fund Matters
Murray, Carolyn	Larceny by Fraud
Sfafeek, Rahneia	Larceny by Fraud
MHC, Limited	Contract Fraud
Rainman, Lionel	Contract Fraud
Bryden, Dennis J.	Contract Fraud

NAVAL INVESTIGATIVE SERVICE (NIS)

TITLE	CATEGORY OF INVESTIGATION	
Brent, Dickinson T.	Procurement Fraud:	Forgery/Progress Payment Claims
Metal Services, Incorporated, MSI	Procurement Fraud:	Product Substitution/ Nonconforming Product
Smith, Lewis C. President, MSI	Procurement Fraud:	Product Substitution/ Nonconforming Product
Roper, Russell D.	Procurement Fraud:	Product Substitution/ Nonconforming Product
Hedden, Jerald R.	Procurement Fraud:	Product Substitution/ Nonconforming Product
General Construction Company	Procurement Fraud:	Product Substitution/ Nonconforming Product
Demaiorbus, Carl	Procurement Fraud:	Product Substitution/ Nonconforming Product
General Dynamics (Electric Boat Division) (2 convictions)	Procurement Fraud:	Product Substitution/ Nonconforming Product
Red Whitehurst & Associates	Procurement Fraud:	Product Substitution/ Nonconforming Product
"SANDFISH" ("Sting" Operation) (13 subjects convicted)	Procurement Fraud:	Product Substitution/ Nonconforming Product
"FLATFISH" ("Sting" Operation) (15 subjects convicted)	Procurement Fraud:	Product Substitution/ Nonconforming Product
AMT Company, Incorporated (3 convictions)	Procurement Fraud:	Cost/Labor Mischarging
P&J Machine Shop, Incorporated	Procurement Fraud	
Gilbert, Edward J.	Procurement Fraud	
Chapman, Kenneth D.	Procurement Fraud	
Just Games, Incorporated	Conflict of Interest	
Gordon, Allen	Conflict of Interest:	Financial Interest in DoD contractor firm
Stanley, Gordon	Conflict of Interest	

TITLE	CATEGORY OF INVESTIGATION
Rose's Oriental Foods	Bribery of Government Official
Mamaril, Antonio	Bribery: Bid Process Irregularities
Drewery, Randoph	Bribery
D'Amore, Jill	Bribery
Callan, M. William	Bribery
Didomenico, Frank	Bribery
Weaver, Michel W.,	Fraud: Miscellaneous
Foster, Delton Lee	Fraud: Miscellaneous
Patten, Roland B	Fraud: Miscellaneous
Pampe, Jeanne F.	Fraud: Miscellaneous
Bruffett, Blair A.	Property Disposal Irregularities
Gonzalis, Julio Garcia	Property Disposal Irregularities
Vasquez, Petee	Property Disposal Irregularities
Tryon, Charles E.	Property Disposal Irregularities
Mendez, Jose Tomas	Property Disposal Irregularities
Krow, Daniel Kee	Property Disposal Irregularities
Southern Commercial, Incorporated	Contract Fraud
North Broward Industries, Incorporated	Contract Fraud
Perkins, Sidney	Contract Fraud
Osser, Bernard	Contract Fraud
Wallace, Preston	Contract Fraud
DiBona, Joseph G. (RDL, Incorporated)	Contract Fraud
Rights, David J. (RDL, Incorporated)	Contract Fraud
Bernesderfer, William	Contract Fraud
Lipschultz, Joel	Contract Fraud
Wirth, Emil	Contract Fraud

DEFENSE CRIMINAL INVESTIGATIVE SERVICE (DCIS)

TITLE	CATEGORY OF INVESTIGATION
McCormack, C.L.	Conflict of Interest - Financial Interest
Afatato, Fabio	Antitrust - Bid Rigging
Berkeley Tomato	Antitrust - Bid Rotation
D.S. Russell Co.	Antitrust - Bid Rotation
H.Seville & Sons	Antitrust - Bid Rotation
Russell, David E	Antitrust - Bid Rotation
Russo, Joseph	Antitrust - Bid Rotation
Russo, Matthew J.	Antitrust - Bid Rotation
Tidewater Prod.	Antitrust - Bid Rotation
Tidewater Produce	Antitrust - Bid Rotation
Wright, Robert	Antitrust - Bid Rotation
Herring, Donald W.	Antitrust - Price Fixing
Beedon, Gerald K.	Procurement - Other
Carter, Edward	Procurement - Other
Gandhi, Chiminlal	Procurement - Other
Kamys, Roger	Procurement - Other
Keown, John T.	Procurement - Other
Kimball, Keith R.	Procurement - Other
Lambert, Robert D.	Procurement - Other
Lofgren, Thomas M.	Procurement - Other
M&M Thread	Procurement - Other
Millinoff, Michael	Procurement - Other
Onderik,Ernest	Procurement - Other
Plymale, Larry	Procurement - Other
Stacey, Christopher	Procurement - Other
Szymanski, Janet	Procurement - Other
Tron Lawrence A.	Procurement - Other
Valens, Richard	Procurement - Other
ADEC Inc.	Procurement - Undelivered Product
Hicks, Gertrude	Procurement - Undelivered Product
Wirt, David(MIPS)	Procurement - Undelivered Product
Wirt, Gordon(MIPS)	Procurement - Undelivered Product
Wirt, Judith (MIPS)	Procurement - Undelivered Product

Air Conditioning Sup	Procurement - Substitution/Nonconforming Product
American Cotton Yarn	Procurement - Substitution/Nonconforming Product
Buckingham, Ronald	Procurement - Substitution/Nonconforming Product
Certified Prod.	Procurement - Substitution/Nonconforming Product
Compass Microwave	Procurement - Substitution/Nonconforming Product
Diesel Energy	Procurement - Substitution/Nonconforming Product
Foster, Samuel	Procurement - Substitution/Nonconforming Product
Hemberger, John	Procurement - Substitution/Nonconforming Product
Hurley, Ronald J.	Procurement - Substitution/Nonconforming Product
Morck, James	Procurement - Substitution/Nonconforming Product
Murdock Webbing Co.	Procurement - Substitution/Nonconforming Product
National Semiconduct.	Procurement - Substitution/Nonconforming Product
Norwood, David	Procurement - Substitution/Nonconforming Product
Page, Robert K.	Procurement - Substitution/Nonconforming Product
Scott, William N.	Procurement - Substitution/Nonconforming Product
Shane Meat Co.	Procurement - Substitution/Nonconforming Product
Splinter, Barry W.	Procurement - Substitution/Nonconforming Product

Bowery, Robert	Procurement - Cost/Labor Mischarging
Martel, Daniel G.	Procurement - Cost/Labor Mischarging
Martel, Paul E.	Procurement - Cost/Labor Mischarging
Pace Development	Procurement - Cost/Labor Mischarging
Pan, George S.	Procurement - Cost/Labor Mischarging
Pan, Karen	Procurement - Cost/Labor Mischarging
Raycomm, INC.	Procurement - Cost/Labor Mischarging
Raymond,Joseph A.	Procurement - Cost/Labor Mischarging
Simon, Karse	Procurement - Cost/Labor Mischarging
Sperry Un. Def. Sys.	Procurement - Cost/Labor Mischarging
Systems Architects	Procurement - Cost/Labor Mischarging
U.S. Crane Cert	Procurement - Cost/Labor Mischarging

Davey Compressor Co.	Procurement - Defective Pricing
Falso, John P.	Procurement - Defective Pricing
Vickery, David H.	Procurement - Defective Pricing

Boston Pneumatics	Procurement - Progress Payment Claims
Elkin, Bernard	Procurement - Progress Payment Claims
Elkin, Bernard	Procurement - Progress Payment Claims
Manter, Charles	Procurement - Progress Payment Claims

Anderson, Donald	Procurement - Fast Pay Program Claims
Knox, Barry W.	Procurement - Fast Pay Program Claims

Kaser, William	Procurement - Contractor/Subcontractor Kickbacks
Tepfer, Milton	Procurement - Contractor/Subcontractor Kickbacks
Thompson, William C.	Procurement - Contractor/Subcontractor Kickbacks

Commercial Fasteners	Procurement - Buy America Act
Hoestry, Ernest	Procurement - Buy America Act
Medical Devices	Procurement - Buy America Act

Manning, Earl L.	Property Disposal - Other

Fishman, Coleman	Property Disposal - Scrap
Nelson, Charles E.	Property Disposal - Scrap

Boone, Robert E	Government Theft/Embezzlement - Property/Equipment
Brubaker, Leland P.	Government Theft/Embezzlement - Property/Equipment
Carr, Cass J.	Government Theft/Embezzlement - Property/Equipment
Curtis, John C.	Government Theft/Embezzlement - Property/Equipment
Darland, Bruce D	Government Theft/Embezzlement - Property/Equipment
Dean, Warren K. Jr.	Government Theft/Embezzlement - Property/Equipment
Hurst, James	Government Theft/Embezzlement - Property/Equipment
Kendrick, Jerry	Government Theft/Embezzlement - Property/Equipment
Lattarula, Michael	Government Theft/Embezzlement - Property/Equipment
Stewart, Paul Junior	Government Theft/Embezzlement - Property/Equipment
Thompson, Boyd F.	Government Theft/Embezzlement - Property/Equipment

Armstead, Charlene	Government Theft/Embezzlement - Funds
Camp, Betty Lou	Government Theft/Embezzlement - Funds
Clay, Andrew	Government Theft/Embezzlement - Funds
King, Wilbur	Government Theft/Embezzlement - Funds
Konrath, Virginia H.	Government Theft/Embezzlement - Funds
Moore, Martha A.	Government Theft/Embezzlement - Funds
Moore, William E.	Government Theft/Embezzlement - Funds
Walker, Carla	Government Theft/Embezzlement - Funds

Blank, Herman	Subversion of Contract Award Process
Connelly, Hugh J. Jr	Subversion of Contract Award Process
Delsea Fasteners	Subversion of Contract Award Process
DiFrancesco, Amedeo	Subversion of Contract Award Process
Dreas, Francis	Subversion of Contract Award Process
Giannitti, Leone	Subversion of Contract Award Process

Holland, Roger L.	Subversion of Contract Award Process
Huffman, Raymond C.	Subversion of Contract Award Process
Imperial Air Parts	Subversion of Contract Award Process
Industrial Tech, Inc.	Subversion of Contract Award Process
Iocono, L.Anthony	Subversion of Contract Award Process
Parker, Charles E.	Subversion of Contract Award Process
Pescatore, Thomas C	Subversion of Contract Award Process
Petrakis, Gregory	Subversion of Contract Award Process
Pickeral, Charles	Subversion of Contract Award Process
Ream, Bruce	Subversion of Contract Award Process
Standard Air Parts	Subversion of Contract Award Process
White, Francis C. Jr.	Subversion of Contract Award Process

Cassella, Robert R	CHAMPUS - Beneficiary
Darah, Alice F.	CHAMPUS - Beneficiary
Martin, Donald W.	CHAMPUS - Beneficiary
Martin, Earline	CHAMPUS - Beneficiary
Otto, Earline	CHAMPUS - Beneficiary
Riding, Almyrta	CHAMPUS - Beneficiary
Smith, Lou Ann	CHAMPUS - Beneficiary
Stith, Pamela	CHAMPUS - Beneficiary
Tash, Teena	CHAMPUS - Beneficiary
Turner, Thurman	CHAMPUS - Beneficiary

Hedrick, Marilyn L.	CHAMPUS - Other
Johnson, Wallace	CHAMPUS - Other
Ndigbara, Akwaga C.	CHAMPUS - Other
Peele, Glenwood T.	CHAMPUS - Other
Rapone, Anthony J.	CHAMPUS - Other
Southerland, Kathy D.	CHAMPUS - Other
Vane, William	CHAMPUS - Other
White, Joe	CHAMPUS - Other

Arline, Peggy A.	CHAMPUS - Military Dependent
Cooper, Shiela	CHAMPUS - Military Dependent
Deitrick, Maryanne	CHAMPUS - Military Dependent
Sullivan, Jacqueline	CHAMPUS - Military Dependent

Alexander, Dr. Peter	CHAMPUS - Medical Practitioner
Braun, Frank	CHAMPUS - Medical Practitioner
Uphoff, Shirley	CHAMPUS - Medical Practitioner

Mr. Hopkins. Let me conclude by saying this: I have a son who is 14 years old. He has gotten to the age that he is too big to whip. He is a good boy, but occasionally he needs a whipping, but he is too big for me to whip.

Is that what has happened to this Government with some of our contractors? Have they gotten too big for us to whip? What do you recommend we do? We have laws to send them to jail. Why can't we get to these people? It has been going on for years. What can we take from them?

Like my son; I can't whip him. So I have to take something away from him. What do you recommend that we take away from these people?

Mr. Taft. I have found an effective way of approaching the problem when you have a problem contractor, and we had one in General Dynamics which we discussed when I was before the committee 2 months ago. We have withheld payments on their current billings of general and administrative expenses. We have had a great deal of cooperation from that company over the past 2 months. They have made a lot of changes. They are making more. They haven't gotten where we want them to be, but we have got a lot of their attention by that withholding of payments.

I have found that to work very well. We have suspension and debarment. There has been in the past, I would say, a reluctance to use some of the authorities we have had. This administration has increased greatly the use of suspension and debarments, and we are gaining credibility in that.

We also need investigators to find out when things are wrong. We have increased those people. I think the word is getting out that we are serious about this and that we will impose penalties. You have seen headlines of debarments that we have put into effect and penalties that are imposed. Just as much as there is wrong out there, we need to be working on it.

Mr. Hopkins. Thank you, Mr. Taft.

Mr. Chairman and the committee, thank you for your patience.

Mr. Nichols. Mr. Secretary, I was very much interested in what you had to say about subpoena powers, a question asked by Mr. McCloskey. I am advised that, with regard to the auditors that have been requested, it was fully funded——

Mr. Taft. I am delighted to hear that.

Mr. Nichols [continuing]. By the committee, and it will be in the bill when it goes to the floor.

Wishing to be fair with all segments of this issue, and recognizing that in Mr. Bennett's previous bill, the revolving door bill, there is a provision in there which sets up a clearinghouse, so to speak, within the Department of Defense, to respond to questions that may be asked about the legality of hiring of particular individuals that used to work for the Government—this is not in the bill, you understand, but obviously there are some areas in here which are gray areas, which are not clearly defined and which you may not be able to define clearly even with the responsibilities placed on you by this bill.

How would you respond to a section in the bill which does indeed set up some sort of a clearinghouse within the Department of Defense where a contractor could go to that clearinghouse and say, hey, is this charge legitimate; can I charge that? What is your view about this particular charge?

Mr. TAFT. I think that it would be useful to have a system, and I believe we do in some informal way, whereby—essentially the way the Commissioner of the IRS does—we can issue an advisory opinion to a contractor as to how the Department will treat a particular controversial, arguable claim.

Mr. NICHOLS. Are you telling me that it is already in place?

Mr. TAFT. We have it on an informal basis.

Maybe Mr. Starrett should speak to that, because it is his office that does this.

Mr. STARRETT. At the major contractor locations, we have a resident office at each one. We have conversations with contractors if they have a question about allowability of certain costs, and we will give them an informal opinion. It is necessary to find out the circumstances behind each and every situation, though. It may look one way on the face of it, but when you get into it you might find something else.

To give you an example—and I noticed in the bill there is the word "model"—well, there are several different kinds of models. One is a production type model, and one is a model of something that you are going to give away, so it is necessary to find out exactly what it is that we are talking about before we provide advice. And we have found that the resident auditors on site are able to get that information and provide that advice.

Mr. NICHOLS. Do the contractors utilize this information that is on post? How frequently do they ask for these informal opinions?

Mr. STARRETT. Not as frequently as we would like, I am afraid.

Mr. BENNETT. The problem is they may ask more.

Mr. STARRETT. I think so.

Mr. NICHOLS. Is it a word-of-mouth informal opinion, or is it written?

Mr. STARRETT. It is informal.

Mr. NICHOLS. Very, very informal?

Mr. STARRETT. Yes.

Mr. NICHOLS. Are there other questions from members of the committee?

Mr. Hopkins.

Mr. HOPKINS. Thank you, Mr. Chairman.

Let me ask you this, Mr. Taft, in reference again to title 18, section 287, which is already in the current law. We have now identified the unallowable claims that have been made. With the law on your side, the claims already being identified, what are you going to do about it? Are you going to use the law to your benefit? Are you going to enlist criminal proceedings now against these companies?

Mr. TAFT. What we would do is to look at each particular instance. If it is an unallowable cost, what we do is we first of all, in our judgment, disallow it; and then there would be a second question not resolved simply by our determination that it is unallowable as to whether it fit within the provisions of section 287. As you know, that doesn't say just that the claim is wrong but that it be knowingly intended to deceive—you read it out—and this would go to a question of the intent of the person submitting it.

In a case that looked suspicious to us, we would initiate an investigation, a criminal investigation, which is different from questioning a cost; and if it proved that this was a case that fit the statute, we would refer it to the Department of Justice. That is the course we follow. It is not true of every unallowable cost, that it is knowingly submitted with an intent to deceive, or whatever the terms of the statute are.

Mr. **Hopkins**. What you are saying to me is, you are giving full notice that you will enlist title 18, section 287, to its fullest?

Mr. **Taft**. We do, indeed. And as I say, I think we have been stepping up our referrals to the Department of Justice pursuant to that and other sections over the course of the last several years.

Mr. **Hopkins**. Thank you.

Mr. **Nichols**. Mr. Kasich.

Mr. **Kasich**. I have a question for both gentlemen, and that is on the issue of retainage.

Do you think, in light of the fact that some of these overhead problems have not been settled for a long time, some claims as long as 13 years, it makes sense from both your perspectives to have a provision in the law that would say that only the total percentage of the contract could be paid out until the product is actually delivered and claims are settled?

In other words, on a fighter plane, No. 1, no more than 75 or 80 percent of the total cost of that contract will be paid to the contractor until the plane is delivered; and No. 2, the claims and overhead questions are also solved? Would that, do you believe, give you additional leverage and be in the direction we need to go? It would be a significant and major reform proposal, but I would like you to both comment quickly.

Mr. **Taft**. As I said to the committee when I was before it 2 months ago, I think one of the reasons why a contractor is reluctant to settle—and the General Dynamics Co. was open for 13 years—was because they have the money. When we get ourselves into a position where we have the money, we find that they are a lot more interested in settling. Your proposal would be along those lines, and I think it would be very salutory.

Mr. **Starrett**. I don't really find your proposal to be objectionable, either. But I do believe that when we do have the money for all of the issues that we have with companies, why then that does accomplish it and we are making sure we are in that posture.

Mr. **Nichols**. I have just one final question, Mr. Secretary. I think I speak for all the members of this subcommittee. In this legislation, we are certainly not wanting to establish any layer of bureaucracy to go through. That would not be my intent. We do require you to send a report back to the subcommittee on this thing. We do suggest that the contracting officers look at each of the claims that have been established by the auditors and been thrown out.

Do you see in these two requirements any additional employee requirements?

Mr. **Taft**. I think we can do the report back with the people we have on board. I don't anticipate that to be a problem. We would meet the deadlines that are in the bill.

It is a question of our priorities, and it seems to me that this is our priority.

Mr. NICHOLS. You wouldn't object, then, to language being placed in the report of the bill, which would set out that we would hope that it would not require additional employees?

Mr. TAFT. I am sorry, Mr. Chairman.

Mr. NICHOLS. You wouldn't object if the committee put into the report language to the effect that we didn't want additional employees to be hired or any other layer of bureaucracy established?

Mr. TAFT. That would be fine with us. And we would not only not object to that being in the report; we would of course comply with it.

Mr. BENNETT. Some of the provisions of the bill should help, because it is not debatable now about some items. They cannot be touched by regulation or discussion because, by a fiat of the statute, that should decrease percentage.

Mr. TAFT. I think the requirement for the certificate will perhaps even more substantially reduce the need for our people, because the questionable items will be taken out at the front end.

Mr. NICHOLS. Mr. Kasich's suggestion struck me as a good one. I thought you could do it already. I would like to see language like that. If you have language you could send us to help Mr. Kasich and the committee, that strikes me as very important.

I thought you could withhold payment until the claims are settled. But if you can't, that is a real good way to get attention, I think.

Mr. TAFT. We can and do do it, and have done it in the case of General Dynamics. But his question was a good idea, and we agree with that.

Mr. NICHOLS. I think we ought to work on language like that.

Mr. TAFT. We will work with the committee.

Mr. NICHOLS. Ms. Preston.

Ms. PRESTON. I would like to clarify something that the chairman asked. In the informal clearinghouse that you have, is there a procedure now established where, if you have a question that is brought up under a particular fact situation, there is a ruling issued that in effect would be binding guidance to all of the administrative contracting officers in their negotiations?

Let me give a situation. The auditors testified last week that there were certain fact situations that appear to occur repeatedly, which are resolved differently by different contracting officers; for instance, one example would be where a company loaned equipment to a Boy Scout troop, or gave equipment and the use of their facility to a Boy Scout troop. That situation occurs rather frequently. One year it might be a Girl Scout troop; 1 year a religious group.

But is there an organization that would once and for all settle that particular fact situation and issue guidance so all contracting officers treat it, as to its allowability, in the same manner?

Mr. TAFT. I think that is the way it should be.

Mr. Starrett performs that function for his agency. The contracting officers should be following those centralized decisions. It is an informal process now. And, of course, you don't want every informal question to be made into a Federal case and have a central decision, but in cases where there are central decisions made they should be implemented by everybody the same way for each contractor; no question about that.

Mr. STARRETT. There is an organization called the Indirect Cost Monitoring Office. The acronym is ICMO. That organization is for the purpose of providing contracting officers with consistent guidance on questions that come to them. The problem is, if the cost principles do not cover the item, it is not necessarily binding on the company.

Ms. PRESTON. But if the contracting officer had guidance that he had to follow, the contractor would then be obliged either to litigate that issue and get a resolution once and for all, or have the contracting officer issue an opinion consistent with that which would then be binding for future years.

Is that correct?

Mr. TAFT. That is correct.

Mr. NICHOLS. Other questions?

Thank you, Mr. Secretary.

Mr. TAFT. Thank you, Mr. Chairman.

Mr. NICHOLS. Our next witness is Mr. Paul Math, who is Associate Director of the National Security and International Affairs Division of the U.S. General Accounting Office; along with Mr. Clark Adams, Group Director of the General Accounting Office.

STATEMENTS OF PAUL MATH, ASSOCIATE DIRECTOR OF THE NATIONAL SECURITY AND INTERNATIONAL AFFAIRS DIVISION OF THE U.S. GENERAL ACCOUNTING OFFICE; AND CLARK ADAMS, GROUP DIRECTOR, NATIONAL SECURITY AND INTERNATIONAL AFFAIRS DIVISION, GENERAL ACCOUNTING OFFICE

Mr. MATH. Mr. Chairman, members of the subcommittee, we are pleased to appear before the subcommittee to discuss defense contractors' overhead cost billings and your proposed legislation which is designed to limit the payment of unallowable overhead costs. Overhead or indirect costs at contractors' operations represent a significant amount of costs reimbursed to contractors under Government contracts. On an average, overhead represents almost 66 percent of total inplant costs.

OVERHEAD COST AGREEMENTS

Contractors incur some overhead costs which the Government deems to be unallowable and, therefore, not reimbursable under Government contracts. Unallowable costs are those that under the provisions of any pertinent law, regulation, or contract cannot be included in prices, cost reimbursements, or settlements under a Government contract. The Government, through the Federal Acquisition Regulations [FAR], provides guidance on the allowability of contract costs.

The Department of Defense, through its administrative contracting officers. [ACO's], routinely negotiates final overhead agreements with contractors. These agreements determine what indirect costs are to be allowable for reimbursement in overhead.

The contracting officer has the responsibility to negotiate the overhead agreement with the contractor. In discharging this responsibility, the ACO seeks advice from the Defense Contract Audit

Agency [DCAA], which has the responsibility to audit the books and records of defense contractors and make recommendations to the ACO's regarding the allowability of such costs.

We recognize that overhead negotiations between the Government and its contractors are complex. We believe, however, that these negotiations could be improved considerably if the FAR was less ambiguous in its definitions on the allowability of specific costs.

In fact, it is this ambiguity which has contributed, in large measure, to the inconsistent treatment of questioned costs found in our review of final overhead cost settlements at 12 major DOD contracting activities.

Our review—conducted in 1983—noted that there were numerous instances where DCAA was challenging, as unallowable, significant amounts of contractor costs only to have the ACO's overrule DCAA and allow a significant percentage of the costs questioned by DCAA. We also observed that the ACO, in the interest of expediency, was not preparing adequate documentation regarding the disposition of the costs questioned by DCAA. We have read the testimony presented to this subcommittee by Mr. Cofer on May 15, 1985. The details of that testimony are very consistent with the findings of our review.

Ambiguities in the FAR permit contractors, DCAA, and contracting officers to have different interpretations on allowability. If a contractor believes a specific cost item is subject to interpretation, the contractor generally includes the cost in the overhead.

DCAA, in performing its overhead audits, uses the same FAR criteria, but often arrives at a different interpretation and questions the costs. If the contractor does not concede the questioned costs, they will be introduced into negotiations between the contracting officer and the contractor. Generally, the negotiations are concluded on a total or bottom line basis without specific agreement on individual items that have been identified in a DCAA audit report.

Contractors are reluctant to negotiate and agree to individual cost items questioned by DCAA audit reports. This reluctance apparently stems from the knowledge that once an item of cost is mutually agreed to as being unallowable, cost accounting standard [CAS] 405, "accounting for unallowable costs" would require that, thenceforth, such costs would have to be excluded from any billing, claim or proposal applicable to a Government contract.

CAS 405 was promulgated to facilitate the negotiation, audit, administration, and settlement of contracts by establishing guidelines covering: One, the identification of costs specifically described in FAR as unallowable and, two, the accounting treatment to be accorded such costs.

It is this reluctance to identify and mutually agree to specific cost items on the part of the contractors and the acquiescence to this procedure by ACO's which produces, in large measure the bottom line negotiations which we found so prevalent.

By agreeing to the compromise figure in total, without addressing specific cost items such as airshows, entertainment, or giveaways, contractors can continue, year after year, to keep these costs in the overhead proposal for bottom line negotiations.

We believe a more aggressive pursuit by contracting officers in identifying and documenting, as unallowable, individual items of cost in overhead settlements would contribute to the effectiveness of CAS 405 and represent a major step toward preventing reimbursement of unallowable costs on Government contracts.

On two occasions we testified before the Congress and made recommendations to the Secretary of Defense on the need to strengthen the criteria governing the allowability of defense contractors' public relations costs and the need to improve DOD's system to prevent payment of defense contractors' unallowable overhead costs.

We are pleased to note that a proposed change to FAR is now being circulated for comment. This gives specific definition to public relations and advertising costs and specifically addresses circumstances under which these types of costs are allowable or unallowable.

In addition to recommending that FAR be strengthened, we also recommended that the Secretary direct ACO's to negotiate, settle, and document costs questioned as unallowable by DCAA on overhead claims on an item-by-item basis.

We believe that adoption of the FAR changes we proposed would reduce differences and disagreements among contractors, DCAA, and ACO's, improve overhead negotiations, and reduce inconsistent treatment of costs under FAR section 31.205 "Selected Costs."

We also believe that our recommendation that ACO's negotiate and settle costs on an item-by-item basis would be a significant contribution to the effectiveness of CAS 405. We believe this one action would eliminate the perennial and unproductive negotiations concerning those costs.

H.R. 2397, the concepts of which we support, addresses many of the problems uncovered by your subcommittee and our review concerning the reimbursement of unallowable costs on Government contracts. We would like to address some of the particulars in this bill.

We note, for example, that under the bill the Secretary of Defense in developing specific criteria for cost allowability must consider the best interests of the United States. Although we believe that contractors, as a rule, do not incur costs without what their management deems good reason, the Government, however, should not attempt to determine what are good business costs for any company, but rather should determine those costs which are in its interest and which it chooses to reimburse.

We also strongly favor the provision in H.R. 2397 which provides that costs which are specifically unallowable under one cost principle are not allowable under another related FAR principle. We believe this provision would reduce differences and disagreements among contractors, DCAA, and ACO's, improve overhead negotiations, and reduce inconsistent treatment of questioned costs.

COST DOCUMENTATION

We note that the bill provides for amending the DOD supplement to the FAR that deals with the allowability of contractor costs. As recommended in our previous reports, we suggest that the bill direct the Secretary of Defense to coordinate with the Civilian Agency Acquisition Council in amending the applicable FAR provisions. This will provide for the consistent application of allowability determinations throughout Government contract negotiations.

In addition, we favor the bill's provision that if a contractor's claim is not supported by adequate documentation, the cost becomes expressly unallowable and is not subject to negotiation. In our review we found that on several occasions, ACO's would reinstate questioned costs with little or no evidence provided by the contractors.

For example, one ACO reinstated the entire amount of $87,000 for questioned consulting service costs based on the contractor's oral promise that future billings would be supported.

We also strongly support H.R. 2397's provision that ACO's negotiate and settle questioned costs on an item-by-item basis. This recommendation was included in our May 7, 1985, report to the Secretary of Defense on unallowable costs.

We believe that negotiating and settling questioned costs on an item-by-item basis will enhance the effectiveness of CAS 405. When the contractor and ACO agree that selected costs items are allowable, those costs will be eliminated from future billings. This, in turn, would eliminate recurring negotiations on these costs.

Further, we support the bill's 5-year limitation on the length of duty for ACO's. Although we do not have empirical data to support this view, we believe that the provision should assist in ensuring that unbiased negotiations and decisionmaking are achieved. We note, for example, that DCAA already has a mandatory 5-year rotation policy for its principal auditors located at the various DCAA field audit offices and we believe that this management philosophy should be applicable to ACO's as well.

Regarding the resolution of allowable expenses, H.R. 2397 provides that "Whenever feasible and practicable, the contract auditor may be present at any negotiation or meeting with the contractor * * *." We would suggest that the bill's language be amended so that the requirement is that the contract auditor should be present at all overhead negotiations with the contractor.

Currently, FAR 42.7 "Indirect Cost Rates" provides that in negotiating final indirect cost rates, "individuals or offices that have provided a significant input to the Government position should be invited to attend * * *" the negotiation proceedings.

Our review found, more often than not, that DCAA auditors, while providing significant input—namely, the audit report—were not invited by the ACO's to attend the negotiations. We believe that the Government's negotiating position would be strengthened considerably by DCAA's attendance at these negotiations, and, therefore, nonattendance should be the exception rather than the rule.

In summary, we support the objectives of H.R. 2397 and we believe that this bill addresses most of the significant problems currently surrounding unallowable costs and provides a structure for accomplishing what needs to be done in preventing reimbursement of unallowable costs on Government contracts.

Mr. Chairman, this concludes our prepared statement and we will be pleased to answer any questions you or members of the subcommittee may have.

Mr. NICHOLS. I just want to say to you that, from this Member of Congress, the General Accounting Office has a great deal of credibility. Also, I want to say that the auditors you furnished this subcommittee more than bore out my defense on the strength of the agency, and I hope you will convey my appreciation to the Comptroller General, particularly that of Mr. Warren Nagel, who provided us with the auditors that we had.

We appreciate the job they did.

Mr. MATH. Thank you, Mr. Chairman.

Mr. NICHOLS. Since you brought up the issue of the requirement to sufficiently document a cost by the contractors or it will be deemed unallowable, let me ask you this. We have heard that there may be problems with the contractors on this particular provision, because there seems to be a feeling out there, regardless of the documentation, that the auditors are going to find something wrong with it and throw it out. Is there some generally accepted standard that we might apply which would resolve that problem?

It is an old issue. People had it on their individual income tax; when the IRS comes by, they say, well, they have to find something wrong.

Mr. MATH. In the IRS example, I think the burden of proof is on the individual to show the documentation, and I think that that criteria would also be applicable in this case. Some type of documentation that the auditors can look at, determine what the voucher was for, what was specifically applicable, so that they can determine whether or not it is allowable rather than having a voucher that really does not have an explanation, or the background, or the evidence for the auditor to make an adequate determination of allowability or unallowability.

Mr. NICHOLS. One of the problems that we have found in discussing this with the auditors—they made the interviews and audits for this—is there was a good bit of concern among auditors that we have taken a great deal of time to sit and go over this stack of claims and have thrown this one out and thrown the other one out, and then when the contractor officer took a look at it and, after some dickering, he said, well, let's just horse trade on this and shake hands and settle on a certain figure, and the auditor never knew whether his particular audit had been sustained or not. I am pleased that you recommended that we do this on an item-by-item basis.

May I ask you what response you get from the Defense Department to those recommendations?

Mr. MATH. I think Secretary Taft just mentioned in the earlier testimony that he supported the recommendation on item-by-item settlement. We have not received an official response from the Secretary of Defense on that position as yet, and we were happy to hear that they do support that position. I think it is very important to, as you said, rather than doing it on a bottom line basis, you have the capablity to go back and say, what was allowable, what was unallowable. If they determined that a specific item was unallowable, then CAS 405 comes into play which states that you shall not introduce an item previously determined as unallowable in future negotiations. So it should cut down the number of vouchers, et cetera that the auditors and the contracting officers have to go through each time they negotiate the costs.

Mr. NICHOLS. Do you find the provisions in this bill would establish another layer of bureaucracy or require a whole lot of additional employees to handle it?

Mr. MATH. No, Mr. Chairman; we don't see that to be the case.

Mr. NICHOLS. Mr. Bennett.

Mr. BENNETT. I will yield. I don't have any questions.

Mr. NICHOLS. Mr. McCloskey.

Mr. MCCLOSKEY. No; thank you, Mr. Chairman.

Mr. NICHOLS. Mr. Hopkins.

Mr. HOPKINS. Mr. Math, we have the law already that will penalize these people through criminal proceedings and put them in jail. We have identified, through the work of Mr. Cofer, and others, those people who have submitted unallowable claims. As you are the Associate Director of the General Accounting Office for the National Security and International Affairs Division, is there anything else in your professional opinion that we need to address in this legislation to get at this situation?

Mr. MATH. Not in terms of the legislation. I couldn't go back retrospectively and determine whether or not those specific examples which were determined unallowable in the past would be then subject to the code in terms of fines, penalties, et cetera.

I think the strong point of the legislation is that it says, in the future these items will be specifically unallowable, and it tells the Secretary of Defense that in developing the regulations DOD should make clearly define those that will be unallowable.

Then in the future, if the contractor submits costs and says that they are allowable, I think we now have the criteria to go back and say they were specifically unallowable and then the code could come into effect.

Right now I think because of the ambiguity, I don't know that you could go back retrospectively and say the contractor knew and intended to submit unallowable claims. I think the ambiguity of the regulation allowed them to do that without the fear of criminal or civil penalties.

I think with the tightening of the criteria, the code could come into greater play in the future.

Mr. HOPKINS. The GAO has subpoena power, does it not, Mr. Math?

Mr. MATH. Yes, sir.

Mr. HOPKINS. How many times has the GAO used its subpoena power?

Mr. MATH. We have the power under four pieces of legislation, and we have submitted what we call demand letters, which are—I don't know if we could call them subpoenas—but letters requesting access to information within the Government. In other words, letters to Government agencies saying that we demand access to records. We have submitted 17 demand letters since the legislation went into effect.

Mr. HOPKINS. Could you do it with an individual or a corporation?

Mr. **Math**. Yes; in addition to the demand letters, we have submitted five subpoenas to individual parties that include corporations, so that there are five instances where we went to corporations or individuals and used the subpoena power.

Mr. **Hopkins**. Do you think subpoena power is essential for auditors to do their duty?

Mr. **Math**. Yes, sir. I think it is of extreme benefit, not only the fact that you use it, but the fact that you have it, is a significant benefit in helping the audits.

Mr. **Hopkins**. Thank you very much.

Thank you, Mr. Chairman.

Mr. **Nichols**. Will the gentleman yield on that particular issue?

Mr. **Hopkins**. Yes.

Mr. **Nichols**. The issue of what is subpoenable and what is not subpoenable? Let's take, for instance, the G.E. case in which they plead guilty. I am certain that at some point in time there was an interoffice memorandum or a letter somewhere between some corporate vice president on up to the president, CEO, saying here we have looked at the records and this is what we find and we have done wrong. Should an item like that, an interoffice memorandum, be subpoenaed?

Mr. **Math**. I don't know that I am prepared to answer that question in terms of an individual item or piece of paper. I think the legislation that we are bound by is pretty specific in terms of the contract costs, and those type of items that pertain to the cost of that contract.

Now, if that memo included a listing of costs and a decision as to whether the costs were going to be included or not included in claimed costs, then I think that we would have access rights and we could subpoena that document.

If it is an interoffice memo not related to our audit role and audit responsibility, then it is my opinion that I doubt that we would have access or would be able to subpoena that information.

Mr. **Nichols**. Ms. Preston.

Ms. **Preston**. Mr. Math or Mr. Adams, during the testimony last week, and I believe Mr. Adams was present during the hearing, there was a difference raised between the use of audit determined versus the negotiated method of resolving contractor submissions. My question to you is, Does GAO have an opinion on whether one method is better than another method and, if so, why?

Mr. **Adams**. Let me say that this is an opinion that I would give you as my own. We have not staffed this through the General Accounting Office. However, it is my belief that if you determined overhead rates by audit determination, you would have a stronger control of the kind of costs which are finally placed into overhead at defense contractors.

This was a system that was used quite predominantly many years ago. Later the system was changed to where the determination of overhead by negotiation became more prevalent, I believe probably 15 years ago. I think that quite clearly the sustension rate or the amount of costs which are sustained as being unallowable as challenged by the DCAA is higher under audit determination than it is under the determination through a procurement negotiation.

Ms. **Preston**. Is that because the initial negotiations are done by the auditor before he writes up what his findings are so that, by the time the auditor has reached the point where he writes something as being a difference of opinion between him and a contractor, he may already have resolved things he initially questioned and may, in fact, have resolved them in favor of the contractor, so that your findings will look different because of the way the process is derived?

Mr. **Adams**. Are you suggesting that in the audit determination much of a negotiation is done before the documentation would be submitted?

Ms. **Preston**. Well, before the auditor finally writes up a file and says this is what we cannot agree on and then sends it to the administrative contracting officer for resolution, at that time, he has already cleared up many things that in the negotiated method he would normally write down as his initial review and say these are questionable.

Ultimately the contractor may be able to support those simply because he hadn't provided documentation?

Mr. **Adams**. If the situation you set out were true, I would suspect that the ratio of sustension would climb higher. I suspect that if the scenario you established were true you would find that less costs were being overruled by the ACO's because most of the questionable costs would have been taken out of the system before the final allowability decision was made.

Under audit determination I suspect what happens is you have the people who are more knowledgeable about the contractors' costs of account, the auditor, doing the preparation and the documenting. In essence the auditor would be doing the negotiating with the contractors. Under such an arrangement I think you have a more knowledgeable contractual relationship.

Ms. **Preston**. May I just ask one final question on that? Is it not true that under each method the administrative contracting officer will make the final decision regardless of which procedure you choose?

Mr. **Adams**. That is true. The ACO, the contracting officer, is the person that has the warrant, the authority to commit the United States, and that is the only person who has that authority. The man with the warrant, the ACO, in the final analysis, has to make the decision.

Mr. **Nichols**. Thank you, Mr. Adams.

Mr. Bennett.

Mr. **Bennett**. Before you leave, I note that you have recommended that we change language on page 8, that it not be just a question of being invited, but should be present, and I hope the staff will look at that.

We did debate that and he has come out strongly for requiring them to be present. On page 7 he suggests that the bill should direct the Secretary of Defense to coordinate with the Civil Aeronautics Council.

I think at least in the report language we probably ought to have something on that.

Mr. **Nichols**. Thank you, gentlemen.

The final witness this morning is Mr. Wilsie Adams, who is an attorney representing the National Security Industrial Association.

You have a prepared statement. It is rather lengthy.

STATEMENT OF WILSIE H. ADAMS, ESQ., REPRESENTING THE NATIONAL SECURITY INDUSTRIAL ASSOCIATION

Mr. **Adams**. I think we would like to read the entire statement. I understand that there are some things in it that raise a lot of questions and that is why we want to read it, so that you can understand the details.

Mr. **Nichols**. We would be delighted to hear from you. Let me ask you this: Are the seven contractors, to whom we sent auditors, all members of your association?

Mr. **Adams**. I would be very surprised if they are not. I did not check to find out and we have not specifically asked any one of those companies for individual comments on the statement I am going to give. Obviously since the bill was only introduced a week ago, we haven't had time to do a lot of coordination with the 370 members of the association.

What I am going to give, I believe, represents a consensus as to the way most of the members would feel about the subject matter of the legislation. If I have any questions which I do not feel comfortable speaking for the association, then I will tell you that that is a personal opinion.

Mr. **Nichols**. You may proceed, sir.

Mr. **Adams**. Before proceeding to a section-by-section analysis of the bill, we would first like to comment on the overall philosophy of the bill. We agree that the regulations regarding allowability of costs can be clarified in some instances. We believe the requirement for public comment on proposed regulations which originated in this subcommittee during the last Congress will assist greatly in that effort.

We do not oppose the imposition of penalties on any contractor who disregards the regulations in the submission of its general and administrative expense rate proposals. Graduated penalties which recognize the degree of culpability of the contractor are appropriate.

We are not opposed to the payment of interest where it can be established that a contractor has had the use of Government funds to which it was not entitled.

We accept the proposition that there should be an obligation on the contractor to take care in the preparation of its proposals and that the burden of identifying unallowable costs should not reside solely with the Government auditor.

We agree that Government auditors can serve a useful role as the adviser to the contractor officer in the conduct of negotiations.

Our differences of opinion and perspective on the bill do not go to the essence of the bill. They are merely a matter of degree. Most of our comments are to what we perceive to be a lack of precision in the language in an area which is highly complex and in which precision is therefore extremely important.

EXPENSE RECOVERY PROCEDURES

As a foundation for our comments, we would like to summarize the procedure by which general and administrative expenses are recovered under the types of contracts covered by the bill. Based on your prior hearings we understand that the committee's interest is primarily directed to general and administrative expense [G&A]. G&A expense is defined in the Federal acquisition regulation as any management, financial, or other expense which is incurred by or allocated to a business unit and which is for the general management and administration of the business unit as a whole.

G&A expenses are recovered by the application of G&A rates to other costs of performance. Each operating division of a company will have a separate G&A rate.

A G&A rate is essentially a percentage factor which when applied to the other costs of contract performance is intended to recover on that contract the allocable portion—appropriate share—of the contractor's total allowable general and administrative expenses for a particular accounting period.

G&A rates are of two basic types, provisional and final. Provisional rates are rates established normally through negotiation, which are used on an interim basis for a variety of purposes.

To illustrate, one use of a provisional rate is in the preparation and submission of bids and proposals for new contracts for future work. Obviously it is necessary to have some basis for estimating what general and administrative expense will be incurred in that future period and what appropriate share of those expenses should be allocated to that contract if it is received.

It is necessary, therefore, to have a provisional G&A rate for bidding and this is normally referred to as a bidding rate. While it might be theoretically possible to prepare a proposal for a different bidding rate for each contract, the level of bidding activity makes such a practice totally impractical.

So the practice is to negotiate a provisional rate to be used in all bids or proposals during a particular period. Whenever there is a significant change in circumstances which would have an impact on the appropriateness of the particular provisional rate, the parties will renegotiate the rate.

For example, if the rate was negotiated on the premise that a division would receive $1 million in business during the year but after 2 months the contractor has been so successful in its work that it now expects to have $1.2 million in business, the provisional rate will be renegotiated downward. It is customary to negotiate provisional rates annually if not more frequently during a given year.

The negotiation of provisional rate is always premised on establishing a rate suitable for the purpose intended; that is, a rate which will result in the recovery of the allowabie share of G&A expenses on the particular contract for which it is used.

A provisional rate is a joint effort by the parties to approximate currently what they will agree finally are the allowable overhead costs on a given contract. It is normal that the Government will insist on and the contractor will agree to a rate which has been deliberately reduced to preclude any possibility of even temporary overrecovery from the use of the provisional rates.

We cannot deny that the use of provisional rates inherently includes the possibility of a temporary overrecovery of costs. But the system also includes the possibility of underrecovery of costs. Many contractors are underpaid for many years. There is no practical, error-free procedure and the current practice has evolved from years of experience on the part of both the Government and its contractors.

The nature of provisional rates makes it necessary ultimately to adjust those rates to the actual incurred G&A expense expended or accrued during the period—that is, final rates must be ascertained. This is accomplished by the submission and negotiation of the final settlement proposal for G&A for the period—usually the contractor's fiscal year—after the books are closed for the period and the actual allowable costs can be ascertained.

It is never possible to know what the total actual costs are or what portion of the total is allowable until after the books are closed. Prior to that time provisional rates based on estimates have been used.

In preparing its G&A expense proposals, whether they be final or provisional, it is never practical to review the perhaps millions of individual cost entries that may have been made during a particular accounting period. Statistically sampling is an acceptable accounting technique.

Each contractor will have a chart of accounts in which it collects the costs attributable to that account. For example, a contractor will normally have an account for advertising for the year. It may have one advertising account or several, so as to distinguish advertising of products from advertising for employment.

Assume that the product advertising account is separate. Being unallowable, that account will not be included in the G&A proposal at all, in accordance with cost accounting standards.

Not all accounts, however, are capable of such distinct definition. Let's say that there is a travel expense account in which travel costs are collected and that that account includes all airfares. It will include the fare whether it was for a coach ticket or for a first-class ticket.

There will necessarily be accounts which contain both allowable and unallowable expenses. There may be thousands of individual entries in that account.

This is where statistical sampling comes in. Let's say there are 10,000 entries and 1,000 is recognized as a representative sample. Of the 1,000 entries audited in the same, 900 are coach tickets, 100 are first-class tickets.

Everyone agrees that the difference between first-class fare and coach fare on 100 trips is unallowable. Let us say that amounts to $2,500 out of a total of $25,000 spent on the 1,000 airfares in the sample or 10 percent of the total. Whatever the total cost is for all 10,000 trips that are in the entire account will be reduced by 10 percent and the reduced amount will go into the G&A rate calculation.

In the example, the total costs in the account are being reduced by a percentage representing the unallowable costs. There is a reasonable degree of certainty that there are no unallowable costs reimbursed by the use of such a technique in the G&A rate. It will always be possible, however, to look at the account and find an example of an individual unallowable expense even though the total has been reduced.

Obviously, the hypothetical example had to occur after the books were closed. It is well known to this committee that the final rate audits by the DCAA and negotiations are years behind.

Let us extend our hypothetical example to say that the sampling described took place in 1983, of travel that occurred in 1981. It is a pretty sure bet that since 1983 the hypothetical contractor, with the tacit, if not express agreement of DCAA, has been consistently reducing its travel account by 10 percent ever since on every G&A rate proposal submitted whether provisional or final.

Thus far I have said nothing about the many judgment calls that the individual bookkeepers are called upon to make each year in deciding to which account a particular expense belongs at the time it is incurred.

Take the recent example of the expenses relating to the treaty signing ceremony with which the committee is familiar. Someone had to make a judgment as to whether that cost is unallowable entertainment or allowable business expense in deciding not to put it in the entertainment account in the first instance. You may disagree with the judgment, but I think you will agree that it is a judgment question. No matter how specific the statute or regulations may be, there will be judgments required.

Some costs are clearly unallowable. Some costs are clearly allowable. Some are in the gray area.

I think almost everyone will agree that you cannot eliminate the gray completely. One of the points we want to make is that there are two kinds of gray costs: gray where the regulation cannot be clear, and gray where the regulation is clear while the cost itself is gray—the judgment areas. Where the regulation is clear and the cost is clearly of that type, penalties may be appropriate. But where either the regulation or the cost itself is gray, there should not be a penalty.

Moreover, the contractor should not be penalized where it is using a reasonable percentage basis to remove the unallowable costs from an account even though it will never be able to say specifically which individual items came out of that account with the percentge.

In my example earlier, the hypothetical contractor took out 10 percent of all fares in an effort to remove all first class premium costs. But because it used a percentage, the contractor cannot say with certainty that it removed all the unallowable and none of the allowable costs.

In fact, it reduced the allowable costs by 10 percent and the unallowable costs by 10 percent. If you own a percentage of a sailboat, or a percentage of a company, or a condominium with a percentage of ownership of the common areas, which physical part do you own? You can't really tell.

With this background, let us turn now to a consideration of the individual sections of the bill.

The penalty provisions are in our opinion too vague for practical application. I repeat, we have no problem with the concept of penalties, but we must be exact in their application. We should start with the phrase "submits for reimbursement." What does that mean?

It is not defined. Does that mean submitting an invoice? On any of the covered contracts a particular contractor rarely if ever submits an invoice for any particular G&A expense. A rate covering all allowable G&A expenses is used and just like the percentage of the sailboat, no one could ever establish which specific item was in or out of the rate.

Hopefully, the drafters intended a proposal to establish the G&A rate which is not a "request for reimbursement" at all.

If you do mean G&A rate proposals, the language should be clarified. You should also add language to recognize the distinction between provisional and final rate proposals. If you recognize that provisional rates precede the actual incurrence of expenses, you will recognize that it is equally impossible to ascertain whether the provisional rate includes any specific cost not yet experienced, let alone one particular item that is unallowable.

We recognize the phrase "submits for reimbursement" is a phrase recently used by the Department of Defense in its directive regarding the "Certificate of Overhead Costs". The confusion which followed from the use of that phrase was immediate both within the Government and the contractor community. Clarification became the order of the day.

It is still not adequately clarified. We have attached for your records the communications from the Council of Defense and Space Industries Associations [CODSIA] to the Department of Defense on this subject.

We have also attached proposed substitute language which provides for the penalty desired, but which applies it to circumstances limited to final rate proposals after the costs are recorded and can be identified.

We have not included the interest provision. While we have no objection to paying interest where the contractor has been overpaid, it is virtually impossible to tell when that actually happened in given situations. We object strongly to having interest run from the date of a proposal when experience tells us we will not have the opportunity to finalize the rates proposed until several years after it has been submitted.

If an interest provision is to be included, interest should be also paid to the contractor where the use of provisional rates has resulted in an underpayment.

We interpret the phrase "expressly defined as unallowable" to mean that only the act of including unallowable costs in instances where the regulation is clear and the cost is clear will be subject to penalty. Neither gray costs nor gray regulations should result in penalties.

We, therefore, propose an exception to the penalty where the contractor had a "substantial basis for believing the cost to be allowable" in recognition of the judgment calls. The cost may ultimately be disallowed but there should not be a penalty for good faith judgments.

We also propose a clarifying provision to assure that the contract action in disallowing costs is subject to the provisions of the Contract Disputes Act. Although we believe such a result is already intended, we are concerned that the statute might be improperly interpreted as providing for some agency action independent of a contract which would be subject only to a more limited review under the Administrative Procedure Act.

We recommend the deletion of paragraph 2b. We do not believe it is appropriate to define by statute specific unallowable costs. To some degree the subject defies definition with the clarity necessary to allow statutory treatment other than directing regulation on the subject.

We have had regulations on unallowable costs for decades and we agree with the committee that after years and years of experience, after numerous reviews by the DAR council and its predecessors, and after numerous court decisions, the regulations are still not clear. This was confirmed in the hearing of May 8 before this committee.

We recognize the frustration of the Congress with country club dues and donations, et cetera, yet we foresee the necessity for continued care and attention to detail in the maintenance of the prohibitions that is not possible in the legislative process.

Let us look at some examples in this bill.

One, amusement, diversion and social activities. Does this include employee morale and welfare activities currently allowable such as an annual picnic?

The bill itself recognizes the need for illustrative examples due to the inability to precisely define terms. That is the reason we have a regulatory process.

We respectfully suggest that your difficulties in drafting this paragraph confirm the wisdom of leaving this to regulation under guidelines established by Congress.

Two, costs to influence congressional action. No examples or definitions are provided. Does this prohibition include the cost of a subscription to the Congressional Record?

Does it include costs of complying with requests for information from this subcommittee?

How does this prohibition differ from the direction in section (c) that the Secretary write clear regulations on the subject of lobbying?

What about the model built as a contract requirement during the early design stages of the development of a ship or airplane?

The point is that the subject of what is unallowable requires continuous attention as cases, examples and questions arise. That attention is best provided in the regulation process.

You can and will oversee that process required by subparagraph (c). There are several duplications between subparagraphs b and c already including: lobbying, advertising, defense of fraud proceedings, entertainment, dining clubs, and contributions.

We believe you intended in paragraph b to list items already unallowable. To a degree you have. But you are doing so out of the context of the remainder of the regulations which serve to distinguish and clarify your examples.

With regard to the regulation, we have provided in the attachment, technical amendments to this section. We have not recommended changes to the list of subjects to be regulated although we do not believe that many of the items need further clarification at this time.

Primarily our comments relate to the factors to consider in preparing the regulations required by paragraph 1 and the documentation requirements of paragraph 3.

We believe that the direction to the Secretary to consider whether reimbursement is in the "best interests of the United States" is too broadly stated. We believe that the direction should be more narrowly stated and that the current regulations on the allocation of cost provide a better focus.

Thus we recommend that the consideration be whether the cost benefits the United States or is reasonably necessary for the operation of the business. We do not mean that every cost of conducting business be an allowable cost.

We accept, for example, the fact that certain types of advertising, though necessary, will not be allowable costs. But there should be some thought given to the necessity of the cost to the contractor before it is determined that it is in the best interest of the United States not to recognize it as allowable.

The committee must recognize that making necessary costs unallowable does not make them disappear. They must be recovered somewhere, either in increased profits or from other customers.

The Government as a customer must pay its fair share of the cost of doing business like any other customer. To make the other customers pay the Government's share is as much a tax on those other customers as having the Government pay it through a broader tax base in the first instance. Congress and DOD should go very slow in disallowing any cost that it recognizes as a necessary cost of doing business.

With regard to subparagraph 3, we have provided a suggested alternative which we believe addresses the subject of documentation more clearly. We object to the vague subjective standard of "sufficient documentation."

This undefined term will merely result in a never-ending demand for more and more support data. We do not know what "sufficient" means in the context of section 2306 of title X which already requires current, complete and accurate information with its attendant audit rights.

Nor should a disagreement over the level of documentation make a cost "expressly unallowable," thereby invoking the penalty provision or making the type of cost not supported in one instance forever expressly unallowable in the future. Our recommended standard uses the Internal Revenue Code as a standard for the level of documentation. This will avoid disagreements and different standards of recordkeeping.

As previously stated, we welcome the auditor to assist the contractor officer at the negotiations. We are willing to negotiate each item raised. We object to a statutory mandate that each item be settled separately.

In the first place, there is no definition of the term "item" which could literally mean each of the 10,000 air fares referred to in the example. This would be both costly and unmanageable.

Furthermore, we believe it is bad policy for the Government to tie the hands of its negotiators to the degree of requiring separate settlements of each item. This may very well preclude an overall settlement which is more advantageous to the Government than would be the case on an item-by-item basis.

Requiring settlement on each item will likely result in nothing more than a staggering increase in both the time required for resolution and in litigation at substantial increase in cost to both the Government and the contractor.

This committee should recognize that there currently exists a Department of Defense Directive [DOD Directive 7640.2] for the resolution of audit disagreements between the auditor and the contractor officer.

The contractor officer is required to go to higher authority whenever the auditor disagrees and the auditor has a separate avenue to appeal these decisions of the contractor officer. We view the requirement for settlement of each item as imposing on the contractor an unreasonbale burden due to what in most cases is a difference in judgment between the contracting officer charged with the responsibility for the negotiations and his auditor-advisor.

The contractors do not wish to be burdened with the internal Government dispute. A copy of the DOD Directive from the Office of Inspector General is also attached for your reference. We believe that a review of this directive will convince you that the auditors are not impotent in the negotiation process.

We are aware of the recent testimony in which Mr. Williston B. Cofer, Jr., identified the fact that with regard to seven contractors the auditor questioned nearly $110 million in cost while the contractor officer did not agree with the auditor with respect to $40 million.

In appraising these facts, the committee must be aware of the difference in responsibility and perspective between the auditor and contracting officer. It is the duty of the auditor to identify and challenge every judgment.

He may not exercise any judgment himself. The contractor officer rules on the judgments made by the contractor. The auditor would probably admit that if he had the responsibility for settlement he would have reached a conclusion in line with the contractor officer. If he would not admit to this, he should make his complaints under DOD Directive 7640.2.

With regard to certification, we recommend the deletion of the certification requirement. Not only is it already required by DOD instructions, it is unnecessary to bring to bear the penalties of this act and the penalties of the False Statements Act and the False Claims Act.

It suffers from the same lack of clarity described eariler in the phrase "request for reimbursement".

We appreciate that the bill deals only with proposals for final settlement, which is a significant improvement over the current DOD requirements. However, we do not want to see in permanent legislation an unnecessary, poorly worded certification requirement.

We have no comment on what to us appears to be a provision dealing solely with internal department personnel matters.

We agree with the scope of coverage of the bill with respect to definition of covered contracts. I would like to express the appreciation of the association for having had the opportunity to testify and we hope you will consider carefully these comments as you go forward with the bill.

Thank you.

PREPARED STATEMENT OF NATIONAL SECURITY INDUSTRIAL ASSOCIATION BY WILSIE H. ADAMS, JR.

Mr. Chairman, and members of the Armed Services Committee, I am Wilsie H. Adams, Jr., a member of the Procurement Committee of the National Security Industrial Association (NSIA).

On behalf of the NSIA it is my privilege to present the views of the association on H.R. 2397, The Allowable Cost Reform Act.

The National Security Industrial Association is a national organization of more than 370 U.S. manufacturing, research and service companies of all sizes, from all parts of the country, and from all segments of industry interested in and related to our national security. A copy of our annual report, which lists our member companies has been previously furnished to the committee.

Established 40 years ago, NSIA serves essentially as a two-way communication medium between government -- primarily the Department of Defense -- and the industry which supports it. It is our purpose to develop and foster mutual understanding between industrial concerns and any one or more of such government establishments to the end that the problems of each may be considered and resolved through cooperation between such establishments and industry and to assist any one or more of such government establishments with technical information relating to industrial experience and practices.

Before proceeding to a section by section analysis of the bill, we would first like to comment on the overall philosophy of the bill. We agree that the regulations regarding allowability of costs can be clarified in some instances. We believe the requirement for public comment on proposed regulations which originated in this subcommittee during the last Congress will assist greatly in that effort.

We do not oppose the imposition of penalties on any contractor who disregards the regulations in the submission of its general and administrative expense rate proposals. Graduated penalties which recognize the degree of culpability of the contractor are appropriate.

We are not opposed to the payment of interest where it can be established that a contractor has had the use of Government funds to which it was not entitled.

We accept the proposition that there should be an obligation on the contractor to take care in the preparation of its proposals and that the burden of identifying unallowable costs should not reside solely with the Government auditor.

We agree that government auditors can serve a useful role as the advisor to the contracting officer in the conduct of negotiations.

Our differences of opinion and perspective on H.R. 2397 do not go to the essence of the bill. They are a matter of degree. Most of our comments are to what we perceive to be a lack of precision in the language in an area which is highly complex and in which precision is therefore extremely important.

As a foundation for our comments, we would like to summarize the procedure by which general and administrative expenses are recovered under the types of contracts covered by the bill. Based on your prior hearings we understand that the committee's interest is primarily directed to General and Administrative (G&A) expense. "G&A" expense is defined in the Federal Acquisition as any management, financial or other expense which is incurred by or allocated to a business unit and which is for the general management and administration of the business unit as a whole.

G&A expenses are recovered by the application of G&A rates to other costs of performance. Each operating division of a company will have a separate G&A rate.

A G&A rate is essentially a percentage factor which when applied to the other costs of contract performance is intended to recover on that contract the allocable portion (appropriate share) of the contractor's total allowable general and administrative expenses for a particular accounting period.

G&A rates are of two basic types, provisional and final. Provisional rates are rates established normally through negotiation, which are used on an interim basis for a variety of purposes.

To illustrate, one use of a provisional rate is in the preparation and submission of bids and proposals for new contracts for future work. Obviously it is necessary to have some basis for estimating what general and administrative expense will be incurred in that future period and what appropriate share of those expenses should be allocated to that contract if it is received. It is necessary therefore to have a provisional G&A rate for bidding and this is normally referred to as a bidding rate. While it might be theoretically possible to prepare a proposal for a different bidding rate for each contract, the level of bidding activity makes such a practice totally impractical. So the practice is to negotiate a provisional rate to be used in all bids or proposals during a particular period. Whenever there is a significant change in circumstances which would have an impact on the appropriateness of the particular provisional rate, the parties will renegotiate the rate. For example, if the rate was negotiated on the premise that a division would receive a million dollars in business during the year but after two months the contractor has been so successful in its work that it now expects to have $1.2 million in business, the provisional rate will be renegotiated downward. It is customary to negotiate provisional rates annually if not more frequently during a given year.

The negotiation of a provisional rate is always premised on establishing a rate suitable for the purpose intended; that is, a rate which will result in the recovery of the allocable share of

G&A expenses on the particular contract for which it is used. A provisional rate is a joint effort by the parties to approximate currently what they will agree finally are the allowable overhead costs on a given contract. It is normal that, the government will insist on and the contractor will agree to, a rate which has been deliberately reduced to preclude any possibility of even temporary overrecovery from the use of the provisional rates.

We cannot deny that the use of provisional rates inherently includes the possibility of a temporary overrecovering costs. But the system also includes the possibility of underrecovery of costs. Many contractors are underpaid for many years. There is no practial error free procedure and the current practice has evolved from years of experience on the part of both the government and its contractors.

The nature of provisional rates makes it necessary ultimately to adjust those rates to the actual allowable G&A expense expended or accrued during the period (i.e. final rates). This is accomplished by the submission and negotiation of the final settlement proposal for G&A for the period (usually the contractor's fiscal year) after the books are closed for the period and the actual allowable costs can be ascertained. It is never possible to know what the total actual costs are or what portion of the total is allowable until after the books are closed. Prior to that time provisional rates based on estimates have been used.

In preparing its G&A proposals, whether they be final or provisional, it is never practical to review the perhaps millions of individual cost entries that may have been made during a period. Statistically sampling is an acceptable accounting technique.

Each contractor will have a chart of accounts in which it collects the costs attributable to that account. For example a contractor will normally have an account for advertising in which it will collect the costs of advertising for the year. It may have one advertising account or several, so as to distinguish advertising of products from advertising for employment. Assume that the product advertising account is separate. Being unallowable, that account will not be included in the G&A proposal at all, in accordance with cost accounting standards.

Not all accounts, however, are capable of such distinct definition. Let's say that there is a travel expense account in which travel costs are collected and that that account includes all airfares. It will include the fare whether it was for a coach ticket or a first class ticket. There will necessarily be accounts which contain both allowable and unallowable expenses. There may be thousands of individual entries in that account. This is where statistical sampling comes in. Let's say there are 10,000 entries and 1,000 is recognized as a representative sample. Of the 1,000 entries audited in the sample 900 are coach tickets, 100 are first-class. Everyone agrees that the difference between first-class fare and coach fare on 100 trips is unallowable. Let us say that amounts to $2,500 out of a total of $25,000 spent on the 1,000 air fares in the sample or 10% of the total. Whatever the total cost is for all 10,000 trips in the account will be reduced by 10 percent and the reduced amount will go into the G&A rate calculation.

In the example the total costs in the account are being reduced by a percentage representing the unallowable costs. There is a reasonable degree of certainty that there are no unallowable costs reimbursed by the use of such a technique in the G&A rate. It will always be possible however to look at the account and find an example of an individual unallowable expense even though the total has been reduce.

Obviously, the hypothetical example had to occur after the books were closed. It is well known to this committee that final rate audits by the DCAA and negotiations are years behind. Let us extend our hypothetical example to say that the sampling described took place in 1983, of travel that occurred in 1981. It is a pretty sure bet that since 1983 the hypothetical contractor, with the tacit if not express agreement of DCAA, has been consistently reducing its travel account by 10% ever since on every G&A rate proposal submitted whether provisional or final.

Thus far I have said nothing about the many judgment calls that the individual bookkeepers are called upon to make each year in deciding to which account a particular expense belongs at the time it is incurred. Take the recent example of the expenses relating to the Treaty Signing Ceremony with which the committee is familiar. Someone had to make a judgment as to whether that cost is unallowable entertainment or allowable business expense in deciding not to put it in the entertainment account in the first instance. You may disagree with the judgment but I think you will agree that it is a judgment. No matter how specific the statute or regulations may be there will be judgments required.

Some costs are clearly unallowable. Some are clearly allowable. Some are in the grey area. I think almost everyone will agree you cannot eliminate the grey completely. One of the points we want to make is that there are two kinds of grey costs: grey where the regulation cannot be clear, and grey where the regulation is clear while the cost itself is grey. Where the regulation is clear and the cost is clearly of that type, penalties may be appropriate. But where either the regulation or the cost is grey there should not be a penalty.

Moreover, the contractor should not be penalized where it is using a reasonable percentage basis to remove the unallowable costs from an account even though it will never be able to say specifically which individual items come out of that account with the percentage. In my example earlier, the hypothetical contractor took out 10% of the allowable coach fares and 10% of all fares in an effort to remove all 1st class premium costs. But because it used a percentage the contractor cannot say with certainty that it removed all the unallowable and none of the allowable costs. In fact it reduced the allowables by 10% and the unallowable by 10%. If you own a percentage of a sailboat, or a percentage of a company, or a condominium with a percentage of the common areas, which physical part do you own?

With this background let us turn now to a consideration of the individual sections of the bill.

SECTION 2

PENALTIES

The penalty provisions are in our opinion too vague for practical application. I repeat we have no problem with the concept of penalties but we must be exact in application. We should start with the phrase "submits for reimbursement." What does that mean? It is not defined. Does that mean submitting an invoice? On any of the covered contracts a contractor rarely if ever submits an invoice for any particular G&A expense. A rate covering all allowable G&A expenses is used and just like the percentage of the sailboat no one could ever establish which specific item was in or out of the rate.

Hopefully, the drafters intended a proposal to establish the G&A rate which is not a "request for reimbursement" at all.

If you do mean G&A proposals, the language should be clarified. You should also add language to recognize the distinction between provisional and final proposals. If you recognize that provisional rates precede the actual incurrence of expenses you will recognize that it is equally impossible to ascertain whether the provisional rate includes any specific cost not yet experienced, let alone one particular item that is unallowable.

We recognize the phrase "submits for reimbursement" is a phrase recently used by the Department of Defense in its directive regarding the "Certificate of Overhead Costs." The confusion which followed from the use of that phrase was so immediate both within the government and the contractor community that clarification became the order of the day. It is still not adequately clarified. We have attached for your records the communications from the Council of Defenses and Space Industries

Associations (CODSIA) to the Department of Defense on this subject.

We have also attached proposed substitute language which provides for the penalty desired but which applies it to circumstances limited to final rate proposals after the costs are recorded and can be identified.

We have not included the interest provision. While we have no objection to paying interest where the contractor has been overpaid, it is virtually impossible to tell when that actually happened in given situtations. We object strongly to having interest run from the date of a proposal when experience tells us we will not have the opportunity to finalize the rates proposed until several years after submission. If an interest provision is to be included, interest should be also paid to the contractor where the use of provisional rates has resulted in an under payment.

We interpret the phrase "expressly defined as unallowable" to mean that only the act of including unallowable costs in instances where the regulation is clear will be subject to penalty. Neither grey costs nor grey regulations should result in penalties. We therefore propose an exception to the penalty where the contractor had a "substantial basis for believing the cost to be allowable" in recognition of the judgment calls. The cost may ultimately be disallowed but there should not be a penalty for good faith judgments.

We also propose a clarifying provision to assure that the contract action in disallowing costs is subject to the provisions of the Contract Disputes Act. Although we believe such a result is already intended, we are concerned that the statute might be improperly interpreted as providing for some agency action independent of a contract which would be subject only to a more limited review under the Administrative Procedure Act.

UNALLOWABLE COSTS

We recommend the deletion of paragraph 2b. We do not believe it is appropriate to define by statute specific unallowable costs. To some degree the subject defies definition with the clarity necessary to allow statutory treatment other than directing regulation on the subject. We have had regulations on unallowable costs for decades and we agree with the committee that after years and years of experience, numerous of reviews by the DAR council and its predecessors, and after numerous court decisions, the regulations are still not clear. This was confirmed in the hearing of May 8 before this committee.

We recognize the frustration of the Congress with country club dues and donations etc. yet we foresee the necessity for continued care and attention to detail in the maintainance of the prohibitions that is not possible in the legislative process.

Let's look as some examples:

(1) amusement, diversion and social activities . . .

Does this include employee morale and welfare activities currently allowable such as an annual picnic?

The bill itself recognizes the need for illustrative examples due to the inability to precisely define terms. That is the reason we have a regulatory process. We respectfully suggest that your difficulties in drafting this paragraph confirm the wisdom of leaving this to regulation under guidelines established by Congress.

(2) Costs to influence congressional action. - No examples or definitions are provided.

Does it include the cost of a subscription to the Congressional Record?

Does it include costs of complying with requests for information from this subcommittee?

How does this prohibition differ from the direction in section (c) for the Secretary to write clear regulations for lobbying?

(9) Models

What about the model built as a contract requirement during the early design stages of the development of a ship or airplane?

The point is that the subject of what is unallowable requires continuous attention as cases, examples and questions arise. That attention is best provided in the regulation process. You can and will oversee the process required by paragraph (c). There are several duplications between b and c already including lobbying, advertising, defense of fraud proceedings, entertainment, and dining club contributions.

We believe you intended in paragraph (b) to list items already unallowable; to a degree you have. But you are doing so out of the context of the remainder of the regulations which serve to distinguish and clarify your examples.

REGULATIONS

We have provided in the attachment, technical amendments to this section. We have not recommended changes to the list of subjects to be regulated although we do not believe that many of the items need further clarification at this time.

Primarily our comments relate to the factors to consider in preparing the regulations in paragraph 1 and the documentation requirements of paragraph 3.

We believe that the direction to the Secretary to consider whether reimbursement is in the "best interests of the United States" is too broadly stated. We believe the direction should be more narrowly stated and that the current regulations on the allocation of cost provide a better focus. Thus we recommend that the consideration be whether the cost benefits the United States or is reasonably necessary for the operation of the business. We do not mean that every cost of conducting business be an allowable cost. We accept, for example, the fact that certain types of advertising though necessary will not be allowable costs. But there should be some thought given to the necessity of the cost to the contractor before it is determined that it is in the best interest of the United States not to recognize it as allowable.

The Committee must recognize that making necessary costs unallowable does not make them disappear. They must be recovered somewhere, either in increased profits or from other customers.

The government as a customer must pay its fair share of the cost of doing business like any other customer. To make the other customers pay the government's share is as much a tax on them as having the government pay it through a broader tax base in the first instance. Congress and DOD should go very slow in disallowing any cost that it recognizes as a necessary cost of doing business.

With regard to subparagraph 3, we have provided a suggested alternative which we believe addresses the subject of documentation more clearly. We object to the vague subjective standard of "sufficient documentation." This undefined term will merely result in a never ending demand for more and more support data. We do not know what "sufficient" means in the context of Section 2306 of title 10 which already requires current complete and accurate information with attendent audit rights. Nor should a disagreement over the level of documentation make a cost "expressly unallowable" thereby invoking the penalty provision or making the type of cost not supported in one instance forever expressly unallowable in the future. Our recommended standard uses the Internal Revenue Code as a standard for the level of documentation. This will avoid disagreements and different standards of record keeping.

RESOLUTION OF ALLOWABLE EXPENSES

As previously stated, we welcome the auditor to assist the contracting officer at the negotiations. We are willing to negotiate each item raised. We object to a statutory mandate that each item be settled separately.

In the first place there is no definition of the term "item" which could literally mean each of the 10,000 air fares referred to in the example. This would be both costly and unmanageable.

Furthermore it is bad policy for the Government to tie the hands of its negotiators to the degree of requiring separate settlements of each item. This may very well preclude an overall settlement which is more advantageous to the Government than would be the case on an item-by-item basis.

Requiring settlement on each item will likely result in nothing more than a staggering increase in both in time for resolution and in litigation at substantial increase in cost to both the government and the contractor.

This committee should recognize that there currently exists a Department of Defense Directive (DOD Directive 7640.2) for the resolution of audit disagreements between the auditor and the contracting officer. The contracting officer is required to go to higher authority when the auditor disagrees and the auditor has a separate avenue to appeal. We view the requirement for settlement of each item as imposing on the contractor an unreasonable burden due to what in most cases is a difference in judgment between the contracting officer charged with the responsibility for the negotiations and his auditor-advisor. The contractors do not wish to be burdened with that internal government dispute. A copy of the DOD Directive from the Office of the Inspector General is also attached for your reference. We believe that a review of this Directive will convince you that the auditors are not impotent in the negotiation process.

We are aware of the recent testimony in which Mr. Williston B. Coffer, Jr. identified the fact that with regard to seven contractors the auditor questioned nearly $110 million in cost while the contracting officer did not agree with the auditor with respect to $40,000,000. In appraising these facts the Committee must be aware of the difference in responsibility and perspective between the auditor and contracting officer. It is the duty of the auditor to identify and challenge every judgment. He may not exercise any judgment himself. The contracting officers rules on the judgments made by the contractor. The auditor would probably admit that if he had the responsibility for settlement he would have reached a conclusion in line with the contracting officer. If he would not admit to this he should make his complaints under DOD Dir. 76402.

CERTIFICATION

We recommend the deletion of the Certification requirement. Not only is it already required by Secretarial decree, it is unnecessary to bring to bear the penalties of this Act and the penalties of the False Statements Act and the False Claims Act. It suffers from the same lack of clarity described earlier in the phrase "request for reimbursement."

We appreciate that the bill deals only with proposals for final settlement which is a significant improvement over the current DOD requirements. However we do not want to see in permanent legislation an unnecessary, poorly worded certification requirement.

LENGTH OF DUTY ASSIGNMENT

We have no comment on what to us appears to be a provision. dealing solely with internal department personnel matters.

COVERED CONTRACTS

We agree with the definition of covered contracts.

In closing we would like to express our appreciation in having had the opportunity to express our views on this very significant legislation. With the technical amendments you have our support. We hope you will consider them carefully as you go forward with this bill.

Thank You.

May 16, 1985

H.R. 2397 -

. . .

SEC. 2. ALLOWABLE CONTRACT COSTS.

(a) PENALTY FOR SUBMISSION OF UNALLOWABLE COSTS. -- The Secretary of Defense shall require that a covered contract provide that--

~~(1) if the contractor submits for reimbursement any cost that has been expressly defined as unallowable by statute or regulation--~~

~~(A) the cost shall be disallowed; and~~

~~(B) the contractor shall be liable to the United States for an amount equal to the amount of the disallowed cost, plus interest; and~~

~~(2) if the contractor submits for reimbursement any cost of a type that has been expressly defined as unallowable by statute or regulation and that has been previously disallowed to that contractor~~

~~(A) The cost shall be disallowed; and~~

~~(b) the contractor shall be liable to the United States for an amount equal to twice the amount of the disallowed cost, plus interest.~~

~~Interest under this subsection shall be computed from the date on which the request for reimbursement of the cost was submitted and at the applicable rate prescribed by the Secretary of the Treasury under section 611 of the Contract Disputes Act of 1978.~~

(1) After final promulgation of the Regulations required by subsection (b), a contractor submits a proposal for general administrative cost settlement for any period after such costs have been expended or accrued which proposal includes any general or administrative cost for which there is clear and convincing evidence that such cost is expressly unallowable under a cost principle established in part 31 of the Federal Acquisition Regulation or the Department of Defense Supplement to the Federal Acquisition Regulation, the cost shall be disallowed. In any case in which a general or administrative cost is unallowable under the preceding sentence, and the contractor shall be liable in an amount equal to the amount of the disallowed cost unless the contractor had a substantial basis for believing that the cost would be allowable.

(2) An action of the Secretary under paragraph (1) shall be considered a final decision for the purposes of section 6 of the Contract Disputes Act of 1978 (41 U.S.C. 605) and shall be appealable in the manner provided in section 7 of such Act (41 U.S.C. 606).

(3) After final promulgation of the Regulations required by subsection (b), if contrary to any advance agreement, a contractor submits a proposal for general and administrative cost settlement for any period after such costs have been expended or

accrued and such proposal includes costs of a type which have previously been finally determined to be expressly unallowable to that contractor pursuant to the regulations required by paragraph (a) above, then the cost shall be disallowed and the Secretary may impose a total penalty on the contractor equal to not more than 2 times the amount of the disallowed costs.

(4) An action of the Secretary under paragraph (3) shall be considered a final decision for the purposes of section 6 of the Contract Disputes Act of 1978 (41 U.S.C. 605) and is appealable in the manner provided in section 7 of such act (41 U.S.C. 606).

~~(b) UNALLOWABLE COSTS. -- The following costs shall not be allowed under a covered contract:~~

~~(1) Costs of amusement, diversion, and social activities and any costs directly associated with such costs (such as tickets to shows or sports events, meals, lodging, rentals, transportation, and gratuities).~~

~~(2) Costs incurred to influence (directly or indirectly) congressional action on any legislation or appropriation matters pending before Congress.~~

~~(3) Defense of any fraud proceeding brought by the United States, unless the contractor is found not to be liable in any way for the alleged fraud.~~

~~(4) Fines and penalties resulting from violations of, or failure of the contractor to comply with, Federal,~~

~~State, or local was and regulations, except when incurred as a result of compliance with specific terms and conditions of the contract or written instructions from the contracting officer;~~

~~(5) Costs of membership in any social or dining club or organization;~~

~~(6) Alcoholic beverages;~~

~~(7) Contributions or donations, regardless of the recipient;~~

~~(8) Advertising designed to promote the contractor or its products;~~

~~(9) Models, gifts, souvenirs, or other memoribilia.~~

~~(c)~~(b) REGULATION RELATING TO ALLOWABLE COSTS. -- (1) Within 120 days after the date of the enactment of this Act, the Secretary of Defense shall publish proposed regulations to amend those provisions of the Department of Defense supplement to the Federal Acquisition Regulations that deal with the allowability of contractor costs reimbursed under Government contracts. In developing specific criteria for the allowability of such costs, the Secretary shall consider whether ~~reimbursement of such costs by the Government is in the best interests of the United States.~~ the costs would benefit the United States or would be reasonably necessary for the operation of the business. The amendments --

(A) shall define in detail and in specific terms those costs that are unallowable under contracts entered into by the Department of Defense; and

(B) shall provide that specific costs ~~specifically~~ unallowable under one cost principle shall not be allowable under another ~~related~~ cost principle.

(2) The amendments under paragraph (1) shall at a minimum clarify the cost principles applicable to contractor costs of the following:

(A) Air shows.
(B) Advertising.
(C) Recruitment.
(D) Entertainment.
(E) Employee morale and welfare.
(F) Social and dining clubs or organizations.
(G) Contributions or donations.
(H) Community relations.
(I) Defense of fraud proceedings.
(J) Fines and penalties.
(K) Dining facilities.
(L) Professional and consulting services.
(M) Compensation.
(N) Selling and marketing.
(O) Travel.
(P) Lobbying.

(Q) Public relations.

(R) Hotel and meal expenses.

(S) Membership in civic, community, and professional organizations.

~~(3) Such amendments shall require that a contractor be required to provide sufficient documentation to support the allowability of a cost at the time cost and pricing data is submitted to the Government pursuant to section 2306 of title 10, United States Code, or at the time a proposed forward pricing agreement or proposal for final settlement is submitted to the Government. If a claim is not supported by adequate documentation, the cost becomes expressly unallowable and is not subject to negotiation.~~

At any time after the effective date of the regulations required by paragraph(b) a contractor submits to the Department of Defense a proposal for either a provisional or final rate for general and administrative expense, the contractor shall identify in the proposal the relevant cost records relied on in the preparation of the proposal. Such identification shall include those records which reflect the amount and purpose of any previously expended or accrued cost relied on in the preparation of the proposal to the same degree required to support the tax deductibility of the expense under the Internal Revenue Code.

If such records are inadequate to support such a tax deduction for any such expended or accrued cost, the unsupported costs shall be considered unallowable in the negotiation of the rate for which the proposal was submitted.

(4) Within 90 days of the date of the enactment of this Act, the Secretary of Defense shall submit to the Committees on Armed Services of the Senate and House of Representatives a report identifying --

(A) the nature of the proposed changes to be made to the current cost principles; and

(B) the potential effect of such changes on future requests for reimbursement of contractor costs.

~~(d)~~ (c) RESOLUTION OF ALLOWABLE EXPENSES. -- The Secretary of Defense shall --

(1) require the negotiation and settlement of each item of cost under a covered contract which is challenged by the Government as being unallowable; and

(2) provide that, whenever feasible and practicable, the contract auditor may be present at any negotiation or meeting with the contractor regarding resolution of allowability of costs submitted to the Government for payment.

~~(e) CERTIFICATION OF ALLOWABLE INDIRECT COSTS. -- (1) If a contractor submits a request for reimbursement of indirect costs for final settlement under a covered contract, the contractor shall be required to certify that all indirect costs included in the request are allowable in accordance with the terms of the~~

~~contract. Any such certification shall be in a form prescribed by the Secretary of Defense.~~

~~(2) The Secretary of Defense or the Secretary of the military department concerned may waive the requirement for certification under paragraph (1) in the case of any contract in an exceptional case if the Secretary --~~

~~(A) determines that it would not be in the interest of the United States to require such certification; and~~

~~(b) states in writing the reasons for that determination.~~

(d) [f becomes d]

(e) [g becomes e]

COUNCIL OF DEFENSE AND SPACE INDUSTRY ASSOCIATIONS (CODSIA)

WASHINGTON, D.C. 20036

March 27, 1985
CODSIA 9-85

The Honorable Caspar W. Weinberger
Secretary of Defense
Washington, D.C. 20301-1000

Dear Mr. Secretary:

The undersigned member associations of the Council of Defense and Space Industrial Associations (CODSIA) take this opportunity to comment on your memorandum of 12 March 1985 to the Secretaries of the Military Departments and Directors of the Defense Agencies, and the attached "Certificate of Overhead Costs." An overwhelming number of our member Association companies have expressed their concern and grave reservations regarding your treatment of this subject.

CODSIA was formed in 1964 by industry associations having common interests in the defense and space fields. The Department of Defense encouraged the formation of this organization as a vehicle for obtaining broad industry reactions to new or revised regulations and similar matters. CODSIA is composed of seven associations, the National Security Industrial Association, the Aerospace Industries Association, the Motor Vehicle Manufacturers Association, the Shipbuilders Council of America, the Electronic Industries Association, the American Electronics Association and the Computer and Business Equipment Manufacturers Association. They represent approximately 3,000 large and small member firms across the nation.

We are in complete agreement with your objective of assuring that defense contractors exclude unallowable cost from overhead rate submittals. This matter is of such importance that we would support an additional procedure to assure these unallowable costs are not included in overhead. However, CODSIA recommends in the strongest terms that your Memorandum of 12 March be rescinded and reexamined in the light of the following considerations:

1. The requirement in paragraph 4 of the Certificate that all costs are "demonstrably related to or necessary for the performance of the Department of Defense contract(s)" conflicts with existing acquisition regulations, including established cost principles, with which contractors are contractually obligated to comply. Paragraph 4 appears to create an entirely new, and excessively restrictive,

standard for allocation of overhead costs to Government contracts. In many instances costs are classified as indirect for the very reason that relationship to a particular cost objective cannot be clearly demonstrated. Costs of corporate management, state and local taxes, some insurance expenses, costs of routine legal, accounting, and other professional services, and other general and administrative expenses are such costs. Procurement regulations have always recognized that these costs are necessary to the overall operation of the business and that a fair portion of these costs should be allocated to Government contracts. FAR §31.201-4(c); DAR §15-201.4(iii). For example, it is not possible to "demonstrate" that the expenses of annual reports, proxy solicitations, and shareholders' meetings are "related to or necessary for" the performance of a Government contract. Yet these routine corporate expenses are essential to the existence of the corporation and are specifically recognized as allowable in the regulations. FAR §31.205-28.

2. The Certificate conflicts with the Cost Accounting Standards and is therefore invalid. The Defense Production Act requires that the Standards promulgated by the Cost Accounting Standards Board "have the full force and effect of law" and "shall be used" by DOD and defense contractors covered by CAS "in estimating, accumulating, and reporting costs in connection with the pricing, administration, and settlement" of negotiated contracts. 50 U.S.C. App. §2168(g) and (i)(A). For example, CAS 403.40(a)(1) requires the allocation of the costs of managing the organization as a whole from the home office to segments. CAS 410.40 requires the allocation of such home office expenses and "the costs of the management and administration of the business unit as a whole" to the contracts of the business unit, including contracts with the Government, using a cost input base. The "demonstrably related to or necessary for" standard imposed by the Certificate of Overhead costs conflicts with these and other Cost Accounting Standards.

3. The Certificate cannot legally be applied to existing contracts. It is well established that the allowability of costs is to be determined on the basis of the regulations in existence on the date the contract is executed. This axiom is expressed, for example, in the standard "Allowable Cost and Payment" clause, FAR §52.216.7. This new Certificate purports to apply immediately to all contracts, including those executed months or years before. By imposing a new, more restrictive allocation standard, the Certificate would retroactively deny contractors reimbursement of costs which were included in the original proposal and considered in establishing the contract price.

4. Perjury is an improper sanction in view of the ambiguity of the Certificate. The applicable perjury statute, 18 U.S.C. §1621(2), penalizes a contractor who "willfully subscribes as true any material matter which he does not believe to be true." Thus, inadvertent mistakes or inclusion of costs believed, even incorrectly, to be allowable within the parameters of the Certificate cannot be the predicate for a perjury prosecution. However, the signing official who reads the Certificate as inconsistent with existing law is confronted with an unacceptable dilemma. If he, for example, believes that paragraph 4 embodies a new, more restrictive test for allocation of costs, he must choose between excluding costs which he is required by CAS to include and entitled to recover under FAR, or commit perjury by including costs which he believes are prohibited by paragraph 4.

5. The Certificate imposes an unreasonable and impractical burden on the corporate official signing the Certificate. The Certificate presupposes that the signing officials will be intimately familiar with every detail of the overhead and general and administrative expenses to which the proposal relates. In many cases, the senior managers, who may be engineers or scientists by training, do not have the expertise or the experience to determine whether costs are allowable under the regulations. They certainly do not have the time to review personally the thousands of accounting entries on which the submission is based.

6. The use of the word "claim" in the Certificate is inappropriate. It appears from your March 12 Memorandum and the language in paragraph 2 of the Certificate that the Certificate is to be executed only when forward pricing, interim billing, or final overhead rate settlement proposals are submitted to the government for approval. Such proposals are not "claims" as that term is defined in FAR 33.001.

7. Overhead proposals are the basis for negotiations between the contractor and the Government. Forward pricing rates, which form the basis of interim billing rates, are estimates of overhead costs expected to be incurred and are negotiated on the basis of historical costs and projections. Final overhead rates are negotiated after the costs are incurred and are based on actual costs. CAS 405 and FAR 31.201-6 already require contractors to identify and exclude from their forward pricing and final overhead rate proposals all costs which are expressly unallowable. Moreover, overhead proposals are carefully audited by DCAA. Inevitably, there will be varying interpretations regarding the allowability of certain expenses, which usually will be resolved through negotiations prior to final agreement. In the end, the contracting officer retains the right to reject the contractor's position and

issue a unilateral final decision. Under these circumstances, it is unreasonable to purport to impose upon the contractor an obligation, under penalty of perjury, to exclude from his proposal costs for which there is legitimate uncertainty as to their allowability.

8. Existing law and regulations are sufficient to protect the Government. In addition to the accounting rules established by the CAS and FAR, the Truth in Negotiations Act requires the contractor to certify that the data supporting his proposal is accurate, current, and complete. The False Claims Act and numerous criminal statutes are already available to punish a contractor who purposely misstates his costs or inflates his claim.

9. The Certificate cannot become effective until published in the Federal Register. Section 1212(a) of the DOD Authorization Act, 1985 (10 U.S.C. §2303a) requires that no procurement policy, regulation, procedure or form can be made effective before it is published, and mandates a period of at least 30 days for public comment. It is doubtful that a basis exists under §2303a(d)(i) for making the Certificate effective during the comment period.

CODSIA shares the concerns expressed in your Memorandum of 12 March 1985. We respectfully request, however, that the Certificate of Overhead Costs be rescinded for the reasons stated above. We would welcome the opportunity to work with you to develop an additional procedure for assuring the exclusion of unallowable overhead costs.

Sincerely,

Jean A. Caffiaux
Senior Vice President
Electronic Industries Association

Wallace H. Robinson, Jr.
President
National Security Industrial Association

Kenneth C. O. Hagerty
Vice President
American Electronics Association

Karl G. Harr
President
Aerospace Industries Association

CERTIFICATE OF OVERHEAD COSTS

This is to certify that:

1. I have reviewed the claim submitted herewith;

2. All costs included in this claim for (overhead costs for rate approval) (final settlement for identify period covered by rate) are allowable in accordance with the requirements of contracts to which they apply and with the cost principles of the Department of Defense applicable to those contracts;

3. This claim does not include any costs which are unallowable under applicable cost principles of the Department of Defense, such as (without limitation): advertising and public relations costs (FAR §31.205-1), contributions and donations (FAR §31.205-8), entertainment costs (FAR §31.205-14), fines and penalties (FAR §31.205-15), lobbying costs (FAR §31.205-22), defense of fraud proceedings (FAR §31.205-47), and goodwill (FAR §31.205-49); and

4. All costs included in this claim benefit the Department of Defense and are demonstrably related to or necessary for the performance of the Department of Defense contract(s) covered by the claim.

I declare under penalty of perjury that the foregoing is true and correct.

Firm:

Signature:

Name of Corporate Official:

Title:

Date of Execution:

COUNCIL OF DEFENSE AND SPACE INDUSTRY ASSOCIATIONS (CODSIA)

WASHINGTON, D.C. 20036

RECEIVED-DARSIA

APR 29 1985

April 26, 1985
CODSIA Case No. 9-85

Defense Acquisition Regulatory Council
Attention: Executive Secretary
OUSDRE(AM)(DARS), c/o OUSDRE(M&RS)
The Pentagon - Room 3D139
Washington, D.C. 20310-3062

Gentlemen:

The undersigned member associations of the Council of Defense and Space Industry Associations (CODSIA) appreciate the opportunity to comment on changes to the DoD FAR Supplement - Parts 242 and 252 which was published by the Department of Defense on March 27, 1985 in the Federal Register. These interim regulations cover requirements for overhead cost certification. Comments on the changes were requested no later than April 26, 1985.

CODSIA was formed in 1964 by industry associations having common interests in the defense and space fields. The Department of Defense encouraged the formation of this organization as a vehicle for obtaining broad industry reactions to new or revised procurement regulations, policies and procedures. CODSIA is composed of seven associations: the Aerospace Industries Association, the American Electronics Association, the Computer and Business Equipment Manufacturers Association, the Electronic Industries Association, the Motor Vehicle Manufacturers Association, the National Security Industrial Association, and the Shipbuilders Council of America. They represent some 4,000 large and small member firms across the nation.

We previously wrote to you on March 27, 1985. In addition to the comments therein, our concerns are as follows:

1. The requirement in paragraph 4 of the Certificate that all costs be "demonstrably related to or necessary for the performance of the Department of Defense contract(s)" conflicts with existing acquisition regulations, including established cost principles and cost accounting standards, with which contractors are obligated to comply. As stated, paragraph 4 seems to describe an entirely new, and excessively restrictive, standard for allocation of overhead costs to Government contracts. Accounting conventions require certain costs to be classified as indirect for the very reason that relationship to a particular final cost objective cannot be clearly

demonstrated. Costs of management, state and local taxes, some insurance expenses, costs of routine legal, accounting, and other professional services, and other general and administrative expenses are examples of such costs. Procurement regulations have always recognized that these costs are necessary to the overall operation of the business and that a fair portion of these costs should be allocated to Government contracts. FAR §31.201-4(c); DAR §15-201.4(iii). For example, it is not possible to show that the expenses of annual reports, proxy solicitations, and shareholders' meetings are "demonstrably related to or necessary for" the performance of a Government contract. Yet these routine corporate expenses are essential to the existence of the corporation, some are specifically required by law and are specifically recognized as allowable in the regulations. FAR §31.205-28.

The Defense Production Act requires that the Standards promulgated by the Cost Accounting Standards Board "have the full force and effect of law" and "shall be used" by DoD and defense contractors covered by CAS "in estimating, accumulating, and reporting costs in connection with the pricing, administration, and settlement" of negotiated contracts.

DoD General Counsel Cox, in his letter to CODSIA dated April 4, 1985, points out that the certificate was not intended to change the FAR which defines standards for allocating indirect costs to Government contracts.

2. The Certificate cannot legally be applied to existing contracts. Federal contract law requires that the allocability of costs is to be determined on the basis of the regulations in existence on the date the contract is executed. By imposing a different and more restrictive allocation standard, the Certificate would retroactively deny contractors contract financing and the reimbursement of costs which were included in the original proposal and relied upon in establishing the contract price. It is a breach of contract to apply the certification requirement to any aspect of current contracts, such as revision of billing rates. In fact, DCAA has unilaterally revised the billing rates of many contractors subsequent to March 20, in violation of FAR 42.704(c), which requires "mutual agreement" to revise a billing rate, once initially "determined" by the responsible auditor or contracting officer. The implementation of the interim rule on

Certification of Overhead Costs (DAR Council memorandum of April 16, 1985) applies to all existing contracts a requirement for a certificate in connection with billing rates "agreed upon, accepted, determined or approved" after March 20, 1985. This is not only a breach of those contracts, but it also creates an illogical rule of requiring contractors to certify an estimate, i.e., "recent review, previous audits or experience or similar reliable data or experience" and in some cases a "detailed rate proposal". Thus, the certification is being applied inappropriately to current contracts.

3. The Certificate imposes an unreasonable and impractical burden on the corporate official signing the Certificate. The Certificate presupposes that the signing officials will be intimately familiar with every detail of the overhead and general and administrative expenses to which the proposal relates. In many cases, particularly among smaller firms, managers may be engineers or scientists by training, or may otherwise lack the expertise, knowledge and experience to determine whether costs are allowable under the regulations. In any event, senior managers should not be expected to review personally the sometimes thousands of accounting entries on which the submission is based.

4. Overhead proposals are the basis for negotiations required by standard contract terms between the contractor and the Government. Forward pricing rates, which form the basis of interim billing rates, are estimates of overhead costs expected to be incurred and are negotiated on the basis of historical costs and projections. Final overhead rates are negotiated after the costs are incurred and are based on actual costs. CAS 405 and FAR 31.201-6 already require contractors to identify and exclude from their final overhead rate proposals all incurred costs which are expressly unallowable and to follow consistently, accounting and estimating practices which will result in excluding expressly unallowable costs from pricing and billing rate proposals. Moreover, overhead proposals are carefully audited by DCAA. Inevitably, there will be varying interpretations regarding the allowability of certain costs which usually will be resolved through negotiations prior to final agreement. In the end, the contracting officer retains the right to reject the contractor's position and issue a unilateral final decision. Under these circumstances, it is unreasonable to purport to impose upon the contractor an obligation,

under penalty of perjury, to exclude from his proposal, costs which are believed to be allowable. Certification should never apply to rate proposals based on estimates. Certification of future projections is unreasonable and impossible.

We are in complete agreement that defense contractors should exclude expressly and agreed unallowable costs from overhead submittals in accordance with the pertinent requirements of contracts and regulation. Contractors are well aware of the obligation to comply with the terms of their contracts and the cost principles and cost accounting standards contained in such contracts. Laws presently in existence are more than sufficient to deter contractors from making false statements and claims to the Government. Where contractors violate these laws, appropriate actions, penalties and sanctions are available.

To add another certification to the many that are already required by law or regulation places an unnecessary additional burden on defense procurement. The existing Certificate of Cost and Pricing Data and the certification required for claims and the provisions of Federal Acquisition Regulations (FAR) (Subpart 42.7 Indirect Cost Rates) cover the concerns which the interim rule attempts to address. The Department of Defense already has abundant authority to deal with contractors who may abuse rules related to overhead cost payment procedures.

Therefore, the interim rule is unnecessary and we recommend that the interim rule be rescinded. However, if a decision is made that a certificate is required, we believe the following changes recommended in Senator Goldwater's letter of April 15 to Secretary Weinberger be made:

1. That paragraph 4 of the Certificate be deleted and the specific FAR standards of allocability and allowability be utilized as the exclusive test.
2. That the senior corporate executive only be required to certify that accountants for the contractors have been instructed to exclude from the proposal, costs which are expressly unallowable under contractual and regulation provisions.

3. That in accordance with the existing law, the penalty for perjury applies only in cases where misrepresentation is intentional. The Certificate signer should be required to affirm only on the basis of his knowledge and belief.

In addition, we also believe the interpretations set forth in the memoranda of April 4 signed by Chapman B. Cox and April 5 by M. A. Gilleece should be specifically reflected in the language of the certificate and the regulation and not merely in peripheral memoranda. Clear, unambiguous, directives are essential. They must be uniformly applied.

We commend OSD efforts to clarify the regulation situation during this interim period. However, industry experience at the field level indicates the need for consistency and flexibility. The directive's disruptive effect on current contract progress payments and negotiations for future contracts has been so great that action must be taken as soon as possible to restore the financing basis upon which current contract performance and pricing are predicated.

As always, we welcome the opportunity to work with you to help assure the economy, efficiency, effectiveness and integrity of federal contracting.

Sincerely,

Karl G. Harr, Jr.
President
Aerospace Industries Association

Jean A. Caffiaux
Senior Vice President
Electronic Industries Association

Kenneth C. O. Hagerty
Vice President,
Government Operations
American Electronics Association

Sheridan Brinley
Motor Vehicle Manufacturers
Association

Ted Heydinger
Ted A. Heydinger
Vice President
Computer & Business Equipment
Manufacturers Association

Wallace H. Robinson, Jr.
President
National Security Industrial
Association

M. Lee Rice
M. Lee Rice
President
Shipbuilders Council of America

United States Senate
COMMITTEE ON ARMED SERVICES
WASHINGTON, DC 20510

April 15, 1985

The Honorable Caspar Weinberger
Secretary of Defense
Department of Defense
Washington, D. C. 20301

Dear Cap:

It has recently come to my attention that you have promulgated a certificate of cost allowability which must be signed by a senior executive of a defense contractor before the Department of Defense will reimburse overhead costs. While I am certainly supportive of your efforts to ensure that expressly unallowable costs are not submitted to the Department for reimbursement, it has come to my attention that several specific details of the certificate that you have issued raise understandable problems.

I think that the certification requirement could be improved and made more realistic with the following changes:

1. Since the General Counsel's letter of April 4 directed to two trade associations indicates that the fourth paragraph of the certificate is not intended to change applicable regulations or principles on cost allowability, there is no practical meaning to the fourth paragraph of the certificate any longer. Accordingly, it would be helpful if that were deleted and if the specific standards of allowability in the FAR were utilized as the exclusive test.

2. It is not realistic to expect a senior corporate official to have reviewed the very large number of items which may constitute a request for overhead reimbursement. It occurs to me that a more reasonable requirement might be to request a certification that accountants for defense contractors have been instructed to prepare overhead cost proposals consistent with certain instructions on allowability of cost prepared by the Department, and that such individuals are further instructed to exclude from the proposal costs which are expressly unallowable under relevant contractual or regulatory provisions. The senior corporate executive can be accountable for ensuring that individuals are given complete and accurate instructions, but it will be difficult to hold such a person directly accountable for any cost submitted.

3. My understanding of existing law related to perjury is that perjury by definition requires some element of knowledge and willfulness. Since this is the case, the certificate would be improved by adding some element of knowledge to the representations made.

I believe that if these three changes could be made in the certificate, it would be substantially improved. Moreover, most of the legitimate concerns expressed about the original certificate would be removed. I would urge you to reconsider the existing form of the certificate and to make the suggested changes listed here.

Sincerely,

Barry

Barry Goldwater
Chairman

DEPARTMENT OF DEFENSE

48 CFR Parts 242 and 252

Defense Acquisition Regulatory System; Availability and Request for Comment on Overhead Cost Certifications; Interim Changes to the DoD FAR Supplement

AGENCY: Department of Defense (DoD).

ACTION: Interim rule and request for comment.

SUMMARY: The Secretary of Defense on March 12, 1985, decided that contractors will be required certify, under penalty of perjury, that all costs included in claims for overhead costs are allowable in accordance with contract requirements and the cost principle applicable to those contracts. Interim changes to DoD FAR Supplement (DFARS) Subparts 242.7 and 252.2 have been issued to require an appropriate certification and preclude contracting officers from accepting overhead cost submissions unless they have been properly certified.

EFFECTIVE DATE: March 20, 1985.

DATES: Any comments on the changes to DFARS 242.7 and 252.2 are to be submitted to the DAR Council no later than April 26, 1985.

ADDRESS: Interested parties may contact the following to obtain copies of the proposed changes and to submit comments: Defense Acquisition Regulatory Council, ATTN: Executive Secretary, OUSDRE(A&M)(DARS), c/o OUSDRE(MARS), Room [illegible], Pentagon, Washington, D.C. 20301-3062.

FOR FURTHER INFORMATION CONTACT: Charles W. Lloyd, Executive Secretary DAR Council, (202) 697-7267.

SUPPLEMENTARY INFORMATION:

Background

The DoD FAR Supplement is codified in Chapter 2, Title 48 of the Code of Federal Regulations.

The October 1, 1984 revision of the CFR is the most recent edition of that title. It reflects amendments to the 1984 edition of the DoD FAR Supplement made by Defense Acquisition Circulars 84-1 through 84-3.

Interested parties may submit proposed revisions to this Supplement directly to the DAR Council.

Interim Changes to 48 CFR 242 and 252

The Department of Defense has issued interim changes to the DoD FAR Supplement to assure that certain acquisition regulations regarding claims for overhead costs are followed. These changes require a company's division Vice President or equivalent to certify that all costs included in claims for overhead costs are allowable in accordance with contract requirements and the cost principles applicable to those contracts. These changes prescribe a specific certification for this purpose and prohibit contracting officers from accepting overhead cost submissions that are not properly certified. Due to urgent and compelling circumstances, these charges are being issued as interm rules wouthout public comment prior to their effectivity.

List of Subjects in 48 CFR Ch. 2

Government procurement.

James T. Brennan,

Director, Defense Acquisition Regulatory Council.

Adoption of Amendments

Therefore, the DoD FAR Supplement contained in 48 CFR Chapter 2 is amended as set forth below.

1. The authority for 48 CFR Chapter 2 reads as follows:

Authority: 5 U.S.C. 301, 10 U.S.C. 2202, DoD Directive 5000.35, and DoD FAR Supplement 201.301.

PART 242—CONTRACT ADMINISTRATION

2. Sections 242.770, 242.770-1 and 242.770-2 are added to read as follows:

242.770 Overhead cost certifications.

242.770-1 Policy.

No submission of a request for payment of indirect costs shall be accepted and no payment shall be made unless such costs have been certified by the contractor's Division Vice President or equivalent, using the Certificate of Overhead Costs in the clause at 252.242-7003. Certification of a request for payment of indirect costs may be made by an individual certification or by a reference to a current certification of the billing rates or final indirect cost rates used in developing the payment request. No agreements on billing rates (including forward pricing rates used as billing rates) or on final indirect cost rates shall be made by the Government without such certification. Changes to previously certified billing rates require a new certification.

242.770-2 Clause.

The contracting officer shall insert the clause at 252.242-7003, "Certification of Overhead Costs (MAR 1985)," in all solicitations and contracts which provide for (a) interim reimbursement of indirect costs, (b) establishment of final indirect cost rates, or (c) contract financing that includes interim payment of indirect cost (e.g., progress payments based on cost and payments based on percentage or stage of physical completion such as shipbuilding).

PART 252—SOLICITATION PROVISIONS AND CONTRACT CLAUSES

3. Section 252.242-7003 is added to read as follows:

252.242-7003 Certification of Overhead Costs.

As prescribed in 242.770-2, insert the following clause:

Certification of Overhead Costs (Mar 1985)

(a) Definition. "Claim," as used in this clause, means any request for payment of overhead costs including a proposal for or an agreement on final indirect cost rates or billing rates (including forward pricing rates used as billing rates).

(b) The Contractor's Division Vice President or equivalent must execute the Certificate in paragraph (c) below for all overhead cost claims. Only upon receipt of the Certificate, or specific reference to same, shall the Contracting Officer act on the Contractor's overhead cost claim.

(c) Certificate of Overhead Costs. The Certificate shall read as follows:

This is to certify that:

1. I have reviewed the claim submitted herewith;

2. All costs included in this claim for (overhead costs for rate approval) (final settlement for identify period covered by rate) are allowable in accordance with the requirements of contracts to which they apply and with the cost principles of the Department of Defense applicable to those contracts;

3. This claim does not include any costs which are unallowable under applicable cost principles of the Department of Defense, such as (without limitation): Advertising and public relations costs (FAR 31.205-1), contributions and donations (FAR 31.205-8), entertainment costs (FAR 31.205-14), fines and penalties (FAR 31.205-15), lobbying costs (FAR 31.205-22), defense of fraud proceedings (FAR 31.205-47), and goodwill (FAR 31.205-49); and

4. All costs included in this claim benefit the Department of Defense and are demonstrably related to or necessary for the performance of the Department of Defense contract(s) covered by the claim.

I declare under penalty of perjury that the foregoing is true and correct.

Firm: ______________________
Signature: ______________________
Name of Corporate Official: ______________________
Title: ______________________
Date of Execution: ______________________

(End of clause)

[FR Doc. 85-7157 Filed 3-26-85; 8:45 am]

BILLING CODE 3810-01-M

December 29, 1982
NUMBER 7640.2

Department of Defense Directive

IG, DoD

SUBJECT: Policy for Followup on Contract Audit Reports

References:
(a) DoD Directive 5000.42, "Policy for Follow-up on Audit Recommendations," August 31, 1981 (hereby canceled)
(b) Office of Management and Budget (OMB) Circular A-50 (Revised), "Audit Followup," September 29, 1982
(c) DoD Directive 5000.41, "Followup on Reports from the General Accounting Office and Audit and Internal Review Organizations of the Department of Defense," March 15, 1982
(d) through (h), see enclosure 1

A. PURPOSE

This Directive reissues reference (a), implements reference (b) by prescribing followup policies and a system for management action on contract audit reports, and assigns responsibilities.

B. APPLICABILITY

This Directive applies to the Office of the Secretary of Defense, the Military Departments, the Organization of the Joint Chiefs of Staff, and the Defense Agencies (hereafter referred to as "DoD Components").

C. POLICY

The Department of Defense recognizes, under reference (c), the need for special guidance for followup on contract audit reports to accommodate the differences between such audits or reviews and those performed by internal auditors. The contract audit followup system provides for (a) tracking and reporting specified types of contract audit reports; (b) a procedure to review differences on the resolution of contract audit recommendations; and (c) an evaluation of the effectiveness of the DoD Components' followup systems.

D. DEFINITIONS

Terms used in this Directive are defined in enclosure 2.

E. PROCEDURES

1. General. Contracting officers and acquisition management officials shall pursue timely resolution and disposition of contract audit reports. Resolution of contract audit reports by law is required within 6 months of report issuance, and disposition normally shall be completed within 6 months. The contract audit followup system shall be structured in consonance with the independent decisionmaking role of the contracting officer and the financial advisory role of the contract auditor.

2. Tracking Requirements

a. All contract audit reports are to be tracked; however, only the contract audits specified in paragraph E.3.a., below, are to be reported. For preaward contract audits, tracking may be accomplished using records maintained in official contract files.

b. Individual procurement or contract administration offices shall track the status of all specified contract audit reports from the date of receipt through final disposition. This information shall be maintained on a current basis and shall serve as the source document for followup status reports. Audit reports may be dropped from the tracking system in the period following closing.

3. Reporting Requirements

a. Audit reports covering forward pricing proposals, advance rate agreements, progress payments, and closing statements are not required to be reported. DoD acquisition and contract administration organizations shall maintain timely and complete information regarding the status of reportable contract audit reports from the time the report is received through final disposition. Reportable audit reports are:

(1) Those containing recommendations covering estimating system surveys, accounting system reviews, internal control reviews, defective pricing reviews, cost accounting standards noncompliance determinations, and operations audits.

(2) Those covering incurred costs, settlement of indirect cost rates, final pricing submissions, termination settlement proposals, equitable adjustment claims, hardship claims, and escalation claims provided reported costs or rates questioned equal $50,000 or more.

b. The information maintained by DoD Components regarding the status of reportable contract audits shall be reported semiannually and include the following data:

(1) For reports closed during the reporting period. The audit report number, report date, contractor name, type of audit, date of disposition, costs questioned or cost avoidance, and costs questioned or avoidance sustained.

(2) For open reports. The audit report number, report date, contractor name, type of audit, amount audited, costs questioned or cost avoidance, whether an independent review was requested, whether the report is pending litigation, whether the report is resolved or unresolved, and disposition target date.

(3) Followup status reports (enclosure 3) for semiannual periods ending March 31 and September 30 shall be submitted to the Inspector General, DoD, (IG), within 30 calendar days after the end of the period.

4. Resolution of Contract Audit Report Recommendations

a. From the time of audit report receipt to the time of final disposition of the audit report, there shall be continuous communication between the auditor and the contracting officer. When the contracting officer's proposed disposition of contract audit report recommendations differs from the contract auditor's report recommendations, and the criteria set forth below are met, the contracting officer's proposed disposition shall be brought promptly to the attention of a designated independent senior acquisition official or board (DISAO) for review. Each DoD acquisition component shall designate a DISAO at each appropriate organizational level who shall review the referred proposed disposition on the following:

(1) All audit reports covering estimating system surveys, accounting system reviews, internal control reviews, defective pricing reviews, cost accounting standards noncompliance reviews, and operations audits.

(2) Audit reports covering incurred costs, settlement of indirect cost rates, final pricings, terminations, equitable adjustment claims, hardship claims, and escalation claims if total costs questioned equal $50,000 or more and differences between the contracting officer and auditor total at least 5 percent of questioned costs.

(3) Prenegotiation objectives for forward pricing actions when questioned costs total at least $500,000 and unresolved differences between the auditor and contracting officer total at least 5 percent of the total questioned costs.

b. Existing acquisition review boards or panels, at appropriate organizational levels, may be designated to perform these functions provided they possess enough independence to conduct an impartial review. The DISAO will receive for review, along with other technical materials, the contract auditor's report. The DISAO shall give careful consideration to recommendations of the auditors, as well as the recommendations rendered by the other members of the contracting officer's team, in reviewing the position of the contracting officer. The DISAO shall provide to the contracting officer, with a copy to the contract auditor, a clear, written recommendation concerning all matters subject to review.

5. Notification of Final Disposition of Contract Audit Report

a. Any followup system requires adequate feedback to the auditor on the final disposition of audit reports. Therefore, the contracting officer shall prepare a memorandum covering the disposition of all audit reports. The memorandum shall discuss the disposition of all audit report recommendations, including the underlying rationale for such dispositions. In the event a DISAO review was obtained, the memorandum also shall discuss the disposition of the DISAO recommendations. A copy of the memorandum shall be provided to the cognizant contract auditor and to the DISAO.

b. Existing feedback reports such as a price negotiation memorandum (DAR 3-811(a), reference (d)) or a written overhead negotiation memorandum (DAR 3-705(b)(5), reference (d)) may be used, when applicable. For all other actions a similar document shall be prepared. To ensure that the final disposition of all audit reports is properly accounted for, each DoD Component's procurement or administrative contracting officer shall notify the cognizant audit office in writing of cancellations of any acquisition action and of any unsuccessful offerors not receiving award of a contract or grant for which an audit report was issued.

6. Recovery of Funds. Policies regarding the DoD credit management and debt collection program are contained in DoD Directive 7045.13 (reference (e)) and in Appendix E of the DAR (reference (d)) for contract debts. Paragraph E.4.f. of DoD Directive 5000.41 (reference (c)) requires the establishment of an account receivable when management agrees with the auditors that resources shall be recovered. General ledger accounts for recording accounts receivable and collections are detailed in Appendix B of DoD 7220.9-H (reference (f)).

7. Coordination with Other Agencies. The cognizant contracting office responsible for acting on contract audit reports that affect contracts of other government agencies shall inform affected organizations of such actions.

F. RESPONSIBILITIES

1. The Secretaries of the Military Departments and the Directors of the Defense Agencies shall:

a. Designate a senior management official (SMO) to serve as a focal point for the audit followup function. The SMO shall be responsible for establishing the DoD Component's followup procedures for contract audits and for the system's overall operation, tracking, and reporting requirements.

b. Designate DISAOs within their DoD Components' procurement and contract administration functions who shall review those cases where the contracting officer's proposed disposition of contract audit report recommendations differs from the contract auditor's report recommendations.

c. Ensure that periodic evaluations of their Components' followup systems are performed to determine that the systems are adequate and result in timely and appropriate resolution and disposition of audit reports. The Military Departments shall have their internal audit organizations perform these reviews. The Assistant Inspector General for Auditing shall review the Defense Agencies' followup systems.

2. The Inspector General, DoD, shall develop policy and monitor and coordinate contract audit followup systems in the Department of Defense. In discharging this responsibility, the IG shall:

a. Develop policy and provide guidance to DoD Components on matters covered under this Directive.

b. Monitor and evaluate program performance and the adherence of DoD Components to contract audit followup policies and procedures.

c. Conduct oversight reviews that are determined necessary to ensure that DoD Components concerned are evaluating effectively contract audit followup systems.

d. Identify cases or areas where contract audit followup procedures can be improved and recommend appropriate corrective action to the DoD Component head concerned.

e. Obtain such reports consistent with the policies of DoD Directive 5000.19 (reference (g)) and conduct oversight reviews necessary to ensure that DoD followup systems are timely and effective.

f. Provide reports to the Secretary of Defense, including those required by OMB Circular A-50 (reference (b)).

3. The Senior Management Official (SMO) for each DoD Component shall:

a. Establish procedures for maintenance of formal records on all applicable contract audit reports covered in section D., enclosure 4.

b. Establish procedures to monitor the timely resolution and disposition of contract audit reports.

c. Maintain consolidated records of the status of all reportable contract audit reports.

d. Prepare the DoD Component's semiannual status report and submit it to the IG in accordance with the procedures in subsection E.3., above, and enclosure 3 of this Directive.

4. The DoD Components' Designated Independent Senior Acquisition Officials or Boards (DISAOs) shall have enough independence to conduct an impartial review of issues brought before them and shall:

a. Review the contracting officer's proposed disposition of contract audit recommendations when the contracting officer proposes to resolve the issue in a manner substantially different from the contract auditor's reported recommendation (see subsection E.4., above). Such reviews shall be initiated by the cognizant contracting officer whose prenegotiation objective or proposed disposition of a contract audit report shall be forwarded for review to the DISAOs. The DISAOs may request that the auditor or contracting officer provide additional input. The DISAOs shall review the issues being referred, make a specific written recommendation to the contracting officer, and provide a copy of the recommendation to the contract auditor concerned.

b. Identify needs for additional or revised guidance or changes in policy or regulatory requirements and forward details to the DoD Component concerned with suggestions for the change or additional guidance needed.

5. Managers of Individual DoD Procurement Contract Administration Offices shall ensure that appropriate action is taken to:

a. Resolve promptly all contract audit reports in accordance with acquisition guidelines and the requirements of this Directive.

b. Track the status of actions on all contract audit reports from the date of receipt through disposition.

c. Establish and monitor procedures to ensure the forwarding of required information to the DISAO responsible for reviewing differences of opinion on contract audit reports.

d. Maintain and provide information required in section E., above.

6. Heads of the Cognizant DoD Internal Audit Organizations shall:

a. Be responsible for internal reviews to determine if the DoD Components' followup systems are adequate and result in timely and appropriate resolution and disposition of audit reports.

b. Complete the first evaluation of the system within 1 year of the system's implementation and perform evaluations not less than every 2 years thereafter.

7. The Director, Defense Contract Audit Agency (DCAA), and Heads of Other Contract Audit Organizations shall:

a. Provide timely and complete support to any DISAO's request for factual information or audit opinions regarding the audit reports under review.

b. Monitor all final disposition and negotiation memoranda received. When the memoranda indicate that a pattern of substantial differences of opinion exists on the disposition of contract audit reports, whether the contracting officer did or did not request reviews by the DISAO, the contract audit field office auditor shall refer the matter to the cognizant DCAA regional director. The regional director shall review these cases with the cognizant SMO. When a memorandum indicates that there is a substantial difference of opinion on the disposition of an audit report, and the contracting officer did not request a review by the DISAO, the auditor shall provide written notification of the observation to the contracting officer requesting that similar differences be elevated for review in the future and maintain a copy of all notifications to be available to the IG and internal auditors, upon request.

c. Provide timely and complete support to the IG and any internal audit organization reviewing a DoD Component's contract audit followup system, in accordance with DoD Instruction 7600.3 (reference (h)).

d. Identify for the DoD procurement or administrative component, at the time of issuance, all contract audit reports reportable under subsection E.3., above, and provide a record of such reports to the DoD Components at least semiannually.

G. INFORMATION REQUIREMENTS

The reporting requirements of this Directive have been assigned Report Control Symbol DD-R&O(SA)1580.

H. EFFECTIVE DATE AND IMPLEMENTATION

This Directive is effective immediately. Forward one copy of implementing documents to the Inspector General, Department of Defense, within 120 days.

Frank C. Carlucci
Deputy Secretary of Defense

Enclosures - 4
1. References
2. Definitions
3. Followup Status Reports
4. Contract Audit Reports Subject to Tracking, Reporting, Resolution, and Notification Requirements

REFERENCES, continued

(d) Defense Acquisition Regulations (DAR)
(e) DoD Directive 7045.13, "DoD Credit Management and Debt Collection Program," July 8, 1982
(f) DoD 7220.9-H, "Accounting Guidance Handbook," February 1, 1978, authorized by DoD Instruction 7220.9, October 22, 1981
(g) DoD Directive 5000.19, "Policies for the Management and Control of Information Requirements," March 12, 1976
(h) DoD Instruction 7600.3, "Internal Audit in the Department of Defense," January 4, 1974

DEFINITIONS

A. Closed Audit Report. An audit report that has been dispositioned.

B. Contract Audit Report. The contract auditor's written advice to a contracting officer advocating specific action on the part of the contracting officer or contractor. An audit report could include amounts questioned or disapproved, exceptions to a contractor's system or operations, usually expressed in terms of cost avoidance, or notification of a contractor's noncompliance with cost accounting standards. Any cost set aside as "unsupported" or "unresolved" will not be considered as a recommendation.

C. Costs Questioned Sustained. That portion of costs questioned by the auditor that is upheld as a result of actions taken by either the contractor or the contracting officer.

D. Disposition of Contract Audit Reports. Contract audit report disposition is achieved when (1) the contractor implements the audit recommendations; or (2) the contracting officer negotiates a settlement with the contractor; or (3) the contracting officer makes a unilateral decision; or (4) a decision has been rendered on an appeal made to the Armed Services Board of Contract Appeals (ASBCA) or U.S. Claims Court; and (5) all corrective actions deemed necessary by the contracting officer have been taken and no further actions can be reasonably anticipated.

E. Litigation. An audit report is in litigation any time an appeal has been filed with the ASBCA or any court concerning an audit recommendation.

F. Open Audit Report. An audit report that has not been dispositioned.

G. Overaged. An audit report that has not been dispositioned and is over 6 months old (from date of issuance) on the "as of" date of the status report.

H. Resolution. The point at which the audit organization and the contracting officer agree on the action to be taken on audit report recommendations; or, in the event of disagreement, when the matters are elevated for review by the DISAO and its recommendations have been considered by the contracting officer and he or she has selected a course of action.

FOLLOWUP STATUS REPORTS
RCS DD-R&O(SA)1580

A. The reports shall provide the information detailed in paragraph E.3.b., basic Directive. All listed reports shall be tracked and reported through final disposition.

B. Each acquisition and contract administration senior management official shall submit a semiannual status report in the attached format. Summary reports for DoD Components shall be submitted to the IG. The reports shall cover the semiannual periods ending March 31 and September 30 and shall be submitted within 30 calendar days after the end of the period. Items shall be removed from the tracking and reporting system in the period following that in which they appeared on the status report as being closed. The first semiannual report shall cover the period ending September 30, 1983.

Attachments - 2
1. Status Report on Specified Contract Audit Reports--Open Reports
2. Status Report on Specified Contract Audit Reports--Reports Closed During Period

STATUS REPORT ON SPECIFIED CONTRACT AUDIT REPORTS
(Report Control Symbol DD-R&O(SA)1580)

OPEN REPORTS

For period ending ____________________
DoD Component ____________________

	Audit Report Number	Report Date[1]	Contractor Name	Type of Audit	Amount Audited	Cost Questioned or Cost Avoidance	Was Independ. Review Requested[2]	Open Pending Litigation[2]	Resolved or Unresolved	Disposition Target Date[1]
A. Overaged Reports										
1. Overaged in prior report										
2. Overaged as of this report										
B. Reports less than 6 months old										

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[1] Year, month, day

[2] Yes (Y), no (N), or not applicable (NA)

STATUS REPORT ON SPECIFIED CONTRACT AUDIT REPORTS
Report Control Symbol DD-R&O(SA)1580

REPORTS CLOSED DURING PERIOD

For period ending ________________
DoD Component ________________

	Audit Report Number	Report Date[1]	Contractor Name	Type of Audit	Date of Disposition[1]	Costs Questioned or Cost Avoidance	Costs Sustained
A. Reports listed as overaged in prior report							
B. Other reports closed during period							

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[1] Year, month, day

CONTRACT AUDIT REPORTS SUBJECT TO TRACKING, REPORTING, RESOLUTION, AND NOTIFICATION REQUIREMENTS

A. Reports Subject to Tracking

All contract [illegible] reports (for preaward contract audits, tracking may be accomplished using records maintained in official contract files).

B. Reports Subject to Tracking and Reporting Requirements of Subsections E.2. and E.3., Basic Directive:

1. All reports with audit recommendations:

   a. Estimating system surveys
   b. Accounting system reviews
   c. Internal control reviews
   d. Defective pricing reviews
   e. Cost accounting standards noncompliance reviews
   f. Operations audits

2. Reports with recommendations and costs questioned of $50,000 or more:

   a. Incurred costs
   b. Settlement of indirect cost rates
   c. Final pricing submissions
   d. Termination settlement proposals
   e. Equitable adjustment claims
   f. Hardship claims
   g. Escalation claims

C. Reports Subject to Resolution of Differences

All contract audit reports.

D. Reports Subject to Resolution and Notification Requirements of Subsections E.4. and E.5., Basic Directive:

1. All reports with audit recommendations:

   a. Estimating system surveys
   b. Accounting system reviews
   c. Internal control reviews
   d. Defective pricing reviews
   e. Cost accounting standards noncompliance reviews
   f. Operations audits

2. Reports with recommendations and costs questioned of $50,000 or more and with unresolved differences between the auditor and contracting officer that total at least 5 percent of total costs questioned:

   a. Incurred costs
   b. Settlement of indirect cost rates
   c. Final pricing submissions
   d. Termination settlement proposals
   e. Equitable adjustment claims
   f. Hardship claims
   g. Escalation claims

3. Reports with recommendations on proposals and costs questioned of $500,000 or more or on rate proposals with a pricing impact equal to at least $500,000 and with unresolved differences between the auditor and contracting officer that total at least 5 percent of total costs questioned:

   a. Forward pricing
   b. Advance rate agreements

Mr. Nichols. Thank you very much, Mr. Adams.

Let me say that we will be marking up this bill tomorrow.

Mr. Wilsie Adams. We were aware of that.

Mr. Nichols. We have your comments. We have your suggestions.

The only thing I see in your testimony that you support is on the last page, where you say "we agree with the definition of covered contracts." Is there anything in this bill——

Mr. Wilsie Adams. We agreed with virtually the entire bill. We agreed with the idea of having the contractor have more responsibility for preparation of his proposals.

We agree with the penalty, that there should be penalty provisions. We agreed with duplicate penalty provisions, with having the auditors at the negotiation table. We agreed with virtually the entire essence of the bill.

We agreed with the clarification of the cost allowability regulations. We have agreed with virtually the entire bill, from our standpoint.

We are trying to tell you, if you are going to have regulations on A through S, don't put A through S in a separate provision out of context to make it specifically unallowable. Don't make models unallowable and destroy the flexibility to deal with a model that is a handout and a memorabilia and the model that is a mockup to help with engineering for production of an airplane.

You can't use a word like "model" in a statute. You need to have flexibility to deal with facts in the regulations.

Mr. Taft asked for that kind of flexibility; we agree it is needed. The model example was the one Mr. Starrett gave as the typical kind of questions that his informal audit opinions deal with.

Don't define as specifically unallowable things that can't be defined adequately in a statute; require the regulations, require them to come here after 90 days and give you 30 days to look at them. Use your oversight responsibility.

We welcome the clarified regulations and the penalties that are based on the regulations, but we don't think you ought to be saying these things are unallowable by statute. It is too difficult to define.

Mr. Nichols. Mr. Bennett.

Mr. Bennett. I had the same reaction that the chairman had to your testimony. I am glad you had a chance to add at the end that there are things you feel are good.

This legislation is likely to be enacted, so it is an opportunity for you to make concrete suggestions.

It is not the fault of this legislative committee that so many errors mounted because of the national scandal. We are trying to see if we can get things in better shape for the future.

On page 9 of your testimony you say, "On any of the covered contracts, a contractor rarely, if ever, submits an invoice for any particular expense."

In my naivete and lack of background on it, I wonder why he doesn't. Why shouldn't he submit an invoice?

Mr. Wilsie Adams. He does submit an invoice, but not specifically for the salary of the manager for any of the general and administrative expenses.

He says, "Here are the direct costs that I incurred in the last reporting period; here is my direct labor, the material costs, and so forth." To that he adds a percentage. That percentage is the G&A rate. That rate normally has been negotiated before the general and administrative expenses have been, in fact, incurred, and it represents the result of negotiations.

What he is saying is that, "of all the general and administrative expenses that I am going to incur during the year, we think that 3 percent, 5 percent, 100 percent, 120 percent, it depends upon the level of business what the rate is." He multiplies that rate that is negotiated, times the costs that have been incurred, and he asks for payment of a dollar figure.

He doesn't ask to be paid for any specific item. He does ask to get paid, but not for any specific item on an invoice.

Mr. **Bennett**. Offhand, it would seem like he should be, and I don't know why you think he shouldn't.

Mr. **Wilsie Adams**. It is not practical and you can't capably do it on a week-to-week basis. The rate——

Mr. **Bennett**. We are not expecting these things to be week to week when we have 13 years of unpaid bills.

Mr. **Wilsie Adams**. Say you are submitting your cost reimbursement invoices on a monthly basis. Let's say you are submitting progress payments on a monthly basis. Say there are some situations in which contractors do invoice on a weekly basis on multiple programs.

There are various periods for invoicing, but the contractor cannot sit down and say that "last week, I spent"—let's pick a clearly allowable cost—"last week I spent $900 on coach airfares and therefore I am submitting an invoice this week for $900 of coach fares," because that is not what those $900 were for. They were for coach fares for the management of the entire operation of the business. He has to take that $900 and spread it over all the contract work over the entire accounting period.

We don't have accounting periods that are weekly or biweekly; they are normally annually. So what has to happen is that that indirect expense has to get pooled into a pool of all airfares; all management-type expenses get put into a pool. Then there is a negotiation of what is in the pool, and using that figure as to the total amounts in the pool, we derive these rates based upon the level of the business activity for the period.

We estimate in advance that during the coming year, I am going to spend for airfares probably in a comparable level to what I did last year, and during the coming year, I am going to have a level of business activity that is a certain level.

Using that, we are able to estimate in advance that if I use this rate consistently over the year, over the period of the year, I am going to come out where I am supposed to be.

Mr. **Bennett**. You are really just telling me that at a particular time, it might be difficult for you to come up with an invoice of an actual expenditure. That is what you are really telling me.

My question is, Why should you ever be paid when you are not able to do that? Eventually, you will be able to do it. Well, you do it now.

Mr. **Wilsie Adams**. Yes.

Mr. Bennett. You do make that judgment eventually. So this would require you to make the judgment before you got the money for it.

Mr. Wilsie Adams. We make the judgment in advance, in negotiations with the Government of provisional rates. We verify those rates at the end of the accounting period through the submission of the final rates.

I think if you looked at the record, you will find that in many, many cases the contractors have not been paid all of their general and administrative expenses as a result of this procedure.

Mr. Bennett. Why don't you have interim payments? I thought you were allowed to have interim payments to see that the company kept afloat.

Mr. Wilsie Adams. You do have interim payments.

Mr. Bennett. Why don't you have interim things conditional upon—eventually you are going to have an actual invoice of expenditures.

Mr. Wilsie Adams. That is what we have. We have actual provisional rates used that are interim and temporary. We get paid as we go along on an interim basis.

Mr. Bennett. You have seldom submitted a particular G&A expense.

Mr. Wilsie Adams. I am saying that if you look at a particular invoice, that invoice during the period of performance rarely will ever express a specific indirect expense. It will always show a rate.

The reason for that is exactly what you are suggesting. We get paid as we go along on a temporary provisional basis subject to later accounting, and a settling-up invoice on each contract after the final rates are negotiated. That is exactly what we are doing.

Mr. Nichols. Mr. Kasich.

Mr. Kasich. I would like to tell you that this weekend I had the opportunity to speak to some of my constituents who work at Rockwell. They are very angry. The employees at the Columbus plant are very angry about the costs that were submitted by the company, because they were bringing the B-1 in under cost and ahead of schedule; and now they are getting a black eye because they are submitting claims for overhead, to try to get things included into overhead that the employees of this company are mad about.

You bring up a technical question about models, and you say: Is Mr. Nichols trying to throw out the models as they relate to something that you make to promote your company versus something that is a mockup to have it built properly? You know well it is not the intent of this committee to deal with eliminating the use of models for mockup.

Frankly, the only reason why these hearings are taking place is because Boeing claimed $105 for corporate officials' traffic tickets in Washington, DC, or that Boeing asked to be reimbursed for this World Paper Airplane Championship, or $45 paid for a disco performance at GD.

Is there an overreaction? The constituents are demanding this. I think that a lot of people in the defense industry agree that we need to do something, because this undermines the credibility.

You should tell us, "We support the bill;" and rather than saying let's not have everything unallowable, give the Secretary of Defense authority to better define that so we don't try to include the cost of models in overhead, that models for mockup will be preserved, but that we aren't going to be paying for a disco performance.

My constituents back home don't want to pay for picnics for defense contractors. Defense contractors have an obligation of maintaining good morale within the company so they can get the job done well and get more contracts. So that ought to be paid for out of their own costs.

I would be willing to bet the employees of Rockwell in Columbus are willing to pay for picnics themselves, or at least have the company pay for it and not the taxpayers.

So don't you think that, in the areas where you say we have some fuzziness and gray areas, like the question of models or the question of entertainment or whatever, you would then support legislation saying that the Secretary of Defense ought to come back in 90 days and define these specific areas?

You certainly agree, I would hope, that amusement, diversion, golf outings should not to be paid for by the taxpayers; do you agree with that?

Mr. **Wilsie Adams**. I would tell you that my statement was that we support this bill completely. We want the Secretary to write the regulations. We want him to come back in 90 days.

I have not addressed the merits or demerits of any particular costs to be allowed or disallowed. All I am saying to you is the same thing the Secretary said: There are some things that are appropriately done by statute and some things that are appropriately done by regulation. And we are saying, do that part by regulation.

I have testified virtually 100 percent in support of the bill. You have summarized my testimony as saying this is what you should say, and that is exactly what I did say.

Mr. **Kasich**. What you say, though, is that we should take the unallowable cost section of this bill, that we define as specifically unallowable, and take it out?

Mr. **Wilsie Adams**. That is correct.

Mr. **Kasich**. I am saying we should leave it in.

And if you have questions about what is exactly defined under the cost, amusement, or diversion or social activities or like, for example, the tickets to a sporting event at the Los Angeles Forum, or whatever, what we should do is just define it.

So we ought to leave that section in there, and we ought to say that these things are allowable; but we want the Secretary to come back in 90 days and say, if you want to keep models for mockups, that is permissible; but any other kind of model is not.

So do you want to amend your testimony, commend Mr. Nichols and Mr. Bennett, and say we should define it more carefully? I don't think any of these people object to that.

Mr. **Wilsie Adams**. I am saying that if you did that, you would end up needing a subcommittee on cost regulations to reexamine those after every court decision, to take a look at them every time any cost accounting technique was changed, and you would have to have the equivalent of a DAR council operating within this committee. And I don't think you want that and I don't think it is a good idea.

I think you can take the message to your constituents, you have gotten the attention of industry. They are up here supporting this bill, up here supporting penalties imposed on contractors, without doing something legislatively that is not a very smart thing to do.

We are up here telling you, yes, clarify the regulations A through S. Recognize that what you are putting in paragraph B you have already got in paragraph C, and use your oversight, tell them to bring the regulations up in 90 days and let you look at them. Just don't do something that puts this committee into the position of being a regulation council.

Mr. Nichols. Mr. Spratt.

Mr. Spratt. Thank you, Mr. Chairman.

Mr. Adams, as I read the proposed language you have submitted, you are mainly making this a G&A bill as opposed to an "other and direct costs" bill.

Mr. Wilsie Adams. That is what we understood was the main focus of the attention of the committee.

Mr. Spratt. I would agree that the itemized disallowed costs statutorily described in the bill are generally administrative costs; but as I read the first part of the bill, it applies to all indirect costs.

What percentage of indirect cost is G&A?

Mr. Wilsie Adams. I am not able to answer that. If I can get advice from an accounting, I will furnish that for the record.

The information was not provided at press time.

Mr. Spratt. Is independent IR&D also included as indirect cost?

Mr. Wilsie Adams. Yes, IR&D is an indirect cost. It can be in the general and administrative expense pool. But depending on the level of the organization, it may be somewhere other than in a particular G&A account; it may be in a home office allocation of G&A.

You have G&A accounts at various levels and I can't tell you where it is at any given point in time.

Mr. Spratt. If we adopted your language as proposed, we would exclude IR&D and confine ourselves solely to disallowance of G&A and penalties for the disallowance of G&A?

Mr. Wilsie Adams. Our language does deal only with G&A. Whether or not that would exclude any specific type of cost always, I don't think so. I am not sure, but I don't believe it would.

Mr. Spratt. A bid or proposal cost is an overhead item put in the pool and allocated out by billing rate, is it not? It may not come out by classification as G&A?

Mr. Wilsie Adams. There are some overhead pools that are not technically G&A pools. There are things like travel that, in one circumstance, would be overhead and, in other circumstances, would be a G&A expense.

I am not trying to mislead the committee with respect to that. What you are dealing with is the G&A area.

What has been coming across to us when people talk about so and so submitted a bill for an airshow or a bill for this or that, what comes across to us is the total lack of understanding on the part of the committee as to what is really happening.

Nobody is submitting a bill for these things. They are saying these things are things that go into the pool to be allocated across all our business. It may be that for any one of those items on the list, the DOD share was only 20 percent of the total and they weren't billed as expenses.

Mr. **Spratt**. But there is a specification of statutory disallowed generic cost—airshows and things like that, alcoholic beverages. Airshows are left open to regulation.

testimony by Mr. Cofer was that we found this, but we certainly bursement any cost that has been expressly defined as unallowable by statute or regulation, then a penalty. Yours says: If the contractor submits any G&A cost which has been disallowed—so it pares it down somewhat.

Mr. **Wilsie Adams**. It pares it back further than that, because I am saying he doesn't even submit a request for payment under my language. All he does is submit a proposal to negotiate to be subject to the penalty.

So we narrowed it in one respect and broadened it in the other respect.

Mr. **Spratt**. The billing rate is a provisional billing rate adjusted at some point in time. I understand that. I think that needs clarification.

Can you give us historic perspective? I asked this question of the staff member who conducted the investigation.

Unallowable costs are running 2.38 percent of the total cost; final resolution, 1.65 percent of total cost. Historically, is that high or low? How does it measure up to the experience since the mid-1960's?

Mr. **Wilsie Adams**. I can't give you any historical perspective on it.

I appreciate the fact that you have noticed what a small percentage of the whole subject we are dealing with when we are talking about these kinds of costs.

The thing that I think you should recognize, also from that same report, is the fact that the contractors prior to submission are taking out more costs than any of the auditors are questioning. There was something like $40 million or $50 million more taken out by the contractors than was questioned.

We are dealing most of the time here in an area of judgment calls: How does this cost compare to the regulation? And it is a judgment call. I think if we have the judgment questions down to about 2 percent, that is pretty damn tight already.

I don't think—you know, we are supportive of the bill, but I don't think that passage of this legislation is going to have some tremendous dollar value impact on the Defense Department budget because we are only dealing in a very, very small percentage in the first place.

Mr. **Nichols**. Let me correct the gentleman in one respect.

On the 2 percent, I believe it is a little erroneous to assume that we are 98 percent, like we are Ivory soap, pure on this thing.

Mr. **Wilsie Adams**. I understand and agree. I recognize that the testimony of Mr. Cofer was that we found this, but we certainly can't look at everything.

I was trying to explain earlier why they can't look at everything. They do the statistical sampling that is intended to result in a reliable result. Industry and the Government does it. Satistical sampling is an accepted practice.

I think it is a pretty safe figure, notwithstanding the fact that they weren't able to look at every single item.

Mr. **Nichols**. I just wanted that figure clarified.

Mr. Hopkins.

Mr. **Hopkins**. Thank you, Mr. Chairman.

Mr. Adams, you are a practicing attorney, is that correct?

Mr. **Wilsie Adams**. Yes. I am a partner in the law firm of McKenna, Connor & Cunio.

Mr. **Hopkins**. And that firm represents the National Security Industrial Association, is that correct?

Mr. **Wilsie Adams**. On this particular matter, we do. We are members of the association, and most of our representation has been on a volunteer status.

Mr. **Hopkins**. You have been getting a lot of practice, by the way. I believe that same organization was before this subcommittee on spare parts a few months ago.

Mr. **Wilsie Adams**. Yes. I testified on spare parts, warranties, H.R. 2545. We supported the committee on a number of efforts last year.

Mr. **Hopkins**. You have 370 members in your organization?

Mr. **Wilsie Adams**. Yes. That is the current estimate, 370 or more.

Mr. **Hopkins**. Of the, shall I say, "Magnificent Seven" that we hear about now so frequently, are all of those members of the National Security Industrial Association?

Mr. **Wilsie Adams**. I did not check the list, but I would assume that they are. If they are not, I would be surprised.

Mr. **Hopkins**. Mr. Cofer testified last week that all seven of those were perhaps guilty of submitting unallowable costs to the Government for deduction.

He further stated that if we had 20, perhaps all 20 of those would have done the same thing.

How deep is that trench? Is it a half inch deep and a mile wide?

You've got 370 members in your organization. Would they all fit into that category, Mr. Adams?

Mr. **Wilsie Adams**. I think Mr. Taft was correct this morning, that you are always going to have disagreements on the judgments, and with every proposal submitted for G&A expense by every contractor, that there will be people who consider some things to be business that the auditor is going to suggest he thinks are entertainment.

It is important that you understand what the auditor's job is here. His job is to come to the contracting officer and say,

> Look, in this submission that I received from the contractor, I am supposed to tell you every judgment that he is making, not whether the judgment is right or wrong. But, hey, look, we have a cost regulation that is subject to interpretation in each and every one of these areas.

Now, he questions a lot of things, and as we have seen, the contracting officer disposes of a lot of those, contrary to the question.

The auditor does not make a determination that this cost included is or is not unallowable. He makes an identification to the contracting officer that "you ought to take a look at this one because this is an area where I could support somebody saying that this cost should be considered entertainment instead of a business meeting."

That is the kind of job that the auditor has. He is supposed to help his negotiator by identifying each and every thing he could possibly identify.

If we are to the situation where that is happening with respect to 2 percent of the costs being submitted, it ain't so terribly bad.

Mr. **Hopkins**. Would you consider it so terribly bad if a high percentage of your 370 members were submitting unallowable costs to the Government that were not supposed to be deducted?

Mr. **Wilsie Adams**. The association is saying to this committee that if they are doing so in disregard of the regulations, without having a substantial basis for believing that those costs are allowable, then they should be penalized.

Mr. **Hopkins**. Let me ask you this as an attorney, Mr. Adams. If that is the case—and I think you are a good attorney—how do you explain, since we have had the law on the books, if you will, for well over 30 years—United States Code, title 18, section 287, that fines people up to $10,000 and 5 years in prison—why that has not been effective?

Mr. **Wilsie Adams**. I don't know that it has not been effective, because you and I are coming from a different perspective.

Mr. **Hopkins**. We have a "Magnificent Seven"—20 companies, according to Mr. Cofer last week—that probably all of them would be guilty.

How many of your 370 would fit into that category? And yet we have a law that says we are going to put you in prison if you are guilty. Yet, nobody is going to prison.

Mr. **Wilsie Adams**. When I read the testimony, he said he could not find that they had done anything criminally wrong.

You have to understand that what is being submitted on a G&A rate proposal, what is submitted is a list of all of the costs of the nature that I have incurred that should be considered in determining the rate.

Now, a lot of those costs come out with the application of percentages where you don't know what has come out and what hasn't. Like I was trying to describe, do you own the sail or the keel? When you take 10 percent out of an account, what has come out?

You can look at the account and see unallowable things in there, but you don't know which is in or out. All you know is that the total has been reduced. That is the way the thing has been approached so far.

Mr. **Hopkins**. In your statement you say the penalty provisions in our bill, in your opinion, are too vague for practical application. Then you say, "I repeat: We have no problem with the concept of penalties, but we must be exact in application."

Mr. **Wilsie Adams**. That is right. That is what is wrong with the statute, why you can't find each one of these things as a violation of title 18.

Title 18 says I am making a claim to get paid, and none of these submissions are claims for payment. Ultimately, you are going to negotiate a rate under which the Government will ultimately reimburse some percentage of that as its share of the total general and administrative expenses incurred.

A company that does 18 to 20 percent of its business with the Government, 18 to 20 percent of the total on that $1 million list, is going to get paid by the Government, not the whole $1 million, only 18 percent of it.

It is a proposal to negotiate, to find what the allocatable rate should be. It is only one portion of the proposal.

There are other aspects of the proposal other than the listing of the costs incurred. There is the business buy-in for part of it, and the rest of it, it is only one portion of it and it is not a request for payment.

Title 18, when you are going to get sent to jail for demanding payment which you weren't entitled to, doesn't even come into play.

Mr. **Hopkins.** So it is ineffective?

Mr. **Wilsie Adams.** Ineffective in preventing what it is not designed to prevent.

It is very effective in preventing people from demanding payments that are contrary to the language of that statute.

Mr. **Hopkins.** You have 370 members in your organization. What do the dues cost?

Mr. **Wilsie Adams.** The dues structure is varied, and I can't tell you what it is. There is a varying dues structure that permits the smaller companies to pay smaller dues than the larger companies in order to be members of the association.

I can submit that for the record.

[The information was not provided at press time.]

Mr. **Hopkins.** Is that deductible?

Mr. **Wilsie Adams.** Deductible——

Mr. **Hopkins.** From their taxes?

Mr. **Wilsie Adams.** The association is a—I believe it is a tax-exempt organization. It is a nonprofit organization.

I believe the membership dues are going to be deductible either as a business expense or for tax purposes, but not as a contribution.

Mr. **Hopkins.** Do you have a political action committee?

Mr. **Wilsie Adams.** I do not believe the association has a political action committee, but I could submit that for the record after I find out.

We are not the general counsel for the association, and I don't know all of the business operations of the association itself.

I can tell you that the charter of the association prohibits it from engaging in lobbying activities. The only time we come over here to provide the views of the association to members or to the committee is when the committee has asked us to.

We do not engage in lobbying activities. It is prohibited by the charter of the association.

[The requested information was not provided at press time.]

Mr. **Hopkins.** A practicing attorney I am not, and I think you are a good lawyer. So I want to ask you to help us in this dilemma that we find ourselves. We want people to pay the penalty. It is that simple. Like the taxpayers do. If the IRS disagrees with them, they can't belong to some association that sends a lawyer up here to protect them. They don't have that privilege. They can't afford it, if you will.

What can we do to convince the taxpayers, who want a strong defense but are now confusing that strong defense with a Government that is not treating them fairly—what can we do to improve this legislation to show these companies that we mean business; that we are tired of them being slapped on the wrist; and that we are going to send some people to prison if they don't straighten out?

You have proven to me that section 18 is ineffective. What do you recommend we do?

Mr. **Wilsie Adams.** Within the confines of this committee, as opposed to the Judiciary or other committees that handle criminal matters, you should pass the bill and make the technical amendments that we have suggested in order to have a workable bill.

We are in favor of passage of the bill with the technical amendments that we have suggested to you, and we think that we have given you help to make it work.

You certainly don't want to pass a bill that says you are subject to a penalty if you request reimbursement, and then 2 years from now or 5 years from now somebody goes to court and says, "You know, when I put a G&A rate on my direct costs, I haven't requested to be paid for that specific thing you are charging me with," and get off. That is what we are telling you the language would permit.

The language as drafted is vague enough to let anybody get off. We are trying to tighten the language down. We have narrowed it to talk only about G&A proposals, but tightened it in a way to make it practically enforceable.

The companies are willing to take the penalties. You have gotten the attention of the industry through these hearings and through the investigations.

The industry is not up here telling you, "Don't pass the bill." You have gotten our attention, and we are trying to be helpful in trying to give you language that will survive in court.

I personally think—this is not an association opinion—my personal opinion as a practicing attorney, you would bring my client up and charge him with a penalty for submitting a rate on an invoice as being a request for reimbursement under penalty provisions, and I think I could get him off.

Mr. **Hopkins.** I appreciate your testimony and patience with me.

I would say, in conclusion, that in my view, David can always whip Goliath when Goliath needs a whipping. I am telling you that time is now. It is going to happen through this bill or written on the floor.

I prefer perfecting the bill as much as possible here. I don't agree with everything you have submitted.

Mr. **Wilsie Adams.** We think Goliath is here trying to help you get the whip in your hand.

We recognize the mood of the public and the mood of Congress, and we know that something is going to happen, and we are trying to suggest ways to make it right.

Mr. **Nichols.** Mr. Kasich.

Mr. KASICH. Mr. Adams, I appreciate what you just said. So I ask you, what if the subcommittee decides we don't want the taxpayers to pay for alcoholic beverages, contributions or donations, regardless of the recipients, or advertising designed to promote the contractor; and you have a question on models, and we don't want to eliminate the mockup models, but we want to eliminate the rest of them?

I don't think there is anything that is questionable about the defense of fraud provision brought before the United States. We don't want that included in there. We don't want the tickets; that is pretty clear.

If you have some areas in this section that we specifically want to say shouldn't be reimbursed, and I think this needs some clarifying, then see Mrs. Preston and give her some of the language that clarifies that, because I think there are people in the industry that don't want to pay these things. And they are mad because they have to come to the Hill and defend us.

Mr. Nichols, Mr. Bennett and this subcommittee decided these specific things should be unallowable. Those areas where you don't think they are clear, come up this afternoon with language; because we are going to clarify models. We need to be more precise on some of that wording. Bring it up. I wish you could do that, and then you could support the first section.

Mr. WILSIE ADAMS. I will do my best.

There are ways to word the first section which we can support, but those words will tend to make it a little more flexible from the standpoint of the Defense Department.

We would say, for example, that these things are unallowable, are generally unallowable, and leave a little room for the exceptions to be brought in by exception.

Mr. KASICH. But alcoholic beverages and memberships to these organizations should never be allowable. We know we don't want those to be allowable.

Those areas that you think are fuzzy, like models, we will look at language; but they should never be allowable for those other things, is what the subcommittee is saying.

Mr. NICHOLS. The gentleman's time has expired.

Thank you, Mr. Adams.

The committee will stand adjourned until 9:30 in the morning in this room when we will mark up the bill.

[Whereupon, at 12:45 p.m., the subcommittee adjourned, to reconvene at 9:30 a.m., on Tuesday, May 21, 1985.]

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